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PEOPLE'S REPUBLIC OF CHINA: THE PROBLEMS OF STRUCTURAL CHANGE

In 1978, the People's Republic of China (PRC) embarked on a programme of structural change designed to transform its economy from a low growth, inflexible one to an economy capable of rapid growth with dramatic increases in the standard of living. The programme was dubbed the "Four Modernizations", and covered agriculture, defense, technology, and industry. However, it is one thing to say the country should modernize while maintaining a socialist structure. In practice, rapid economic development is often difficult for countries to achieve even when they are willing to rely on prices to direct resources in the economy. China's mixture of state planning along with some market pricing has led to many imbalances and counterproductive behavior on the part of economic agents. These were discussed in a previous AMM article, "PRC: Contradictions Between Socialist Principles and 'Capitalist' Development" (AMM, May-June 1986, Vol. 10, No.3). In this article, we will discuss the development of the economy in 1986. In so doing we will attempt to pinpoint precisely where economic agents are given incorrect signals and the effect on the economy of their subsequent actions.

Agriculture and Industry

Agricultural production growth fell dramatically in 1986, to a 3.1% rate of growth from a 13.0% rate in 1985. (See Chart 1.) While the fall from the extremely high rates of growth which occurred immediately after the 1978 reforms was to be expected, agricultural production was clearly affected by the deliberate efforts on the part of the authorities to cool down an overheated economy.

The contracting system, whereby a farmer contracts with his commune to pay agricultural taxes and also sell a fixed amount of grain to the state at a given price, was one of the most important liberalizing actions taken. Most observers regard that action, which partially restored the pre-revolution land tenure system, as the cause of the doubling of agricultural output which occurred over the 1978-86 period. However, the reform has not totally re-established property rights as understood in Western countries. Specifically, the desire to have an equitable distribution of the commune's land led to peasants receiving scattered plots of different quality. The land belongs to the peasant on a fifteen year lease, which is an improvement on the previous system but will still yield a less than optimal amount of investment.

The growth in industrial production in 1986 was half the level of 1985, falling from an unsustainable 18% annual rate to a still quite healthy 9.2%.

However, China's industrial production figure is only indicative of possible GNP growth because it entails a great deal of double counting. The economic planners have deliberately tried to lower the growth rate because the problems of planning, along with uneconomic prices, had led to shortages. Specifically, the economic reforms gave the factory manager more leeway to decide output and retain the proceeds from the incremental production. However, managers have not been given correct input prices on which to base decisions. For example, the price of steel is subsidized greatly by the state and shortages and hoarding have developed. Managers currently have an incentive to buy all the steel they can, regardless of type or quality, and then trade it informally with other managers who have done the same. Market forces have not been allowed to work through the price mechanism. If they had, price increases would have occurred which would have elicited greater supply and lower demand. However, in China's current environment even free prices are not enough to ensure correct responses by managers.

Neither greater supply nor less demand will follow price increases without competition and the profit motive. This is why the Chinese authorities have been reluctant to completely free prices without at the same time changing the incentives facing managers.

The growth rates in industry mask many difficulties in production. For example, estimates by a joint venture project suggest that labor productivity in China is one eighth the amount of workers in factories outside of China, given identical capital equipment.

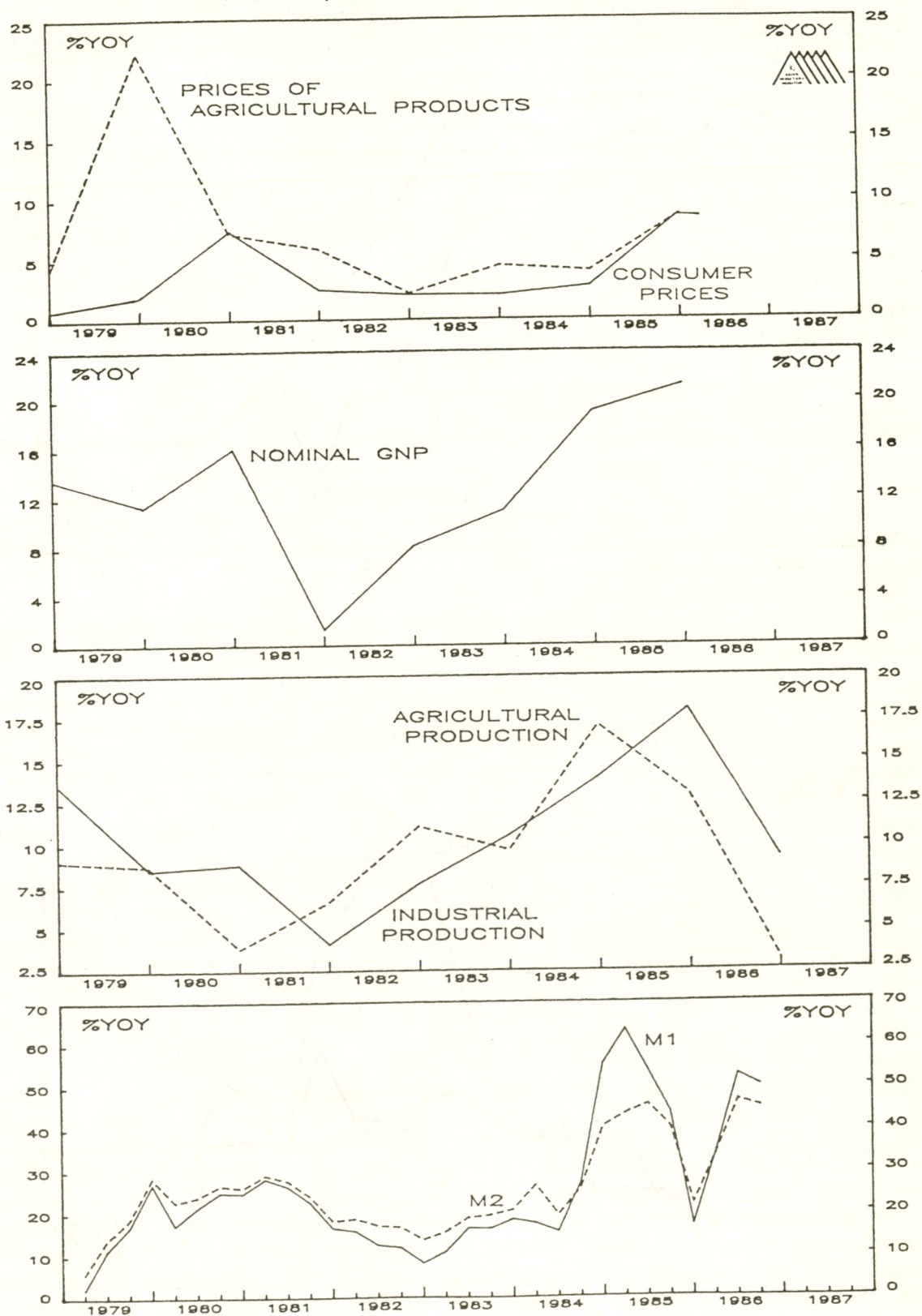
Foreign Trade

China has continued to run a deficit on both the current account and the balance of trade. Estimates of the trade deficit for the last quarter of 1986 show a negative balance of Rmb. 12.7 billion. For the year as a whole the trade balance was in deficit by Rmb. 45.6 billion.

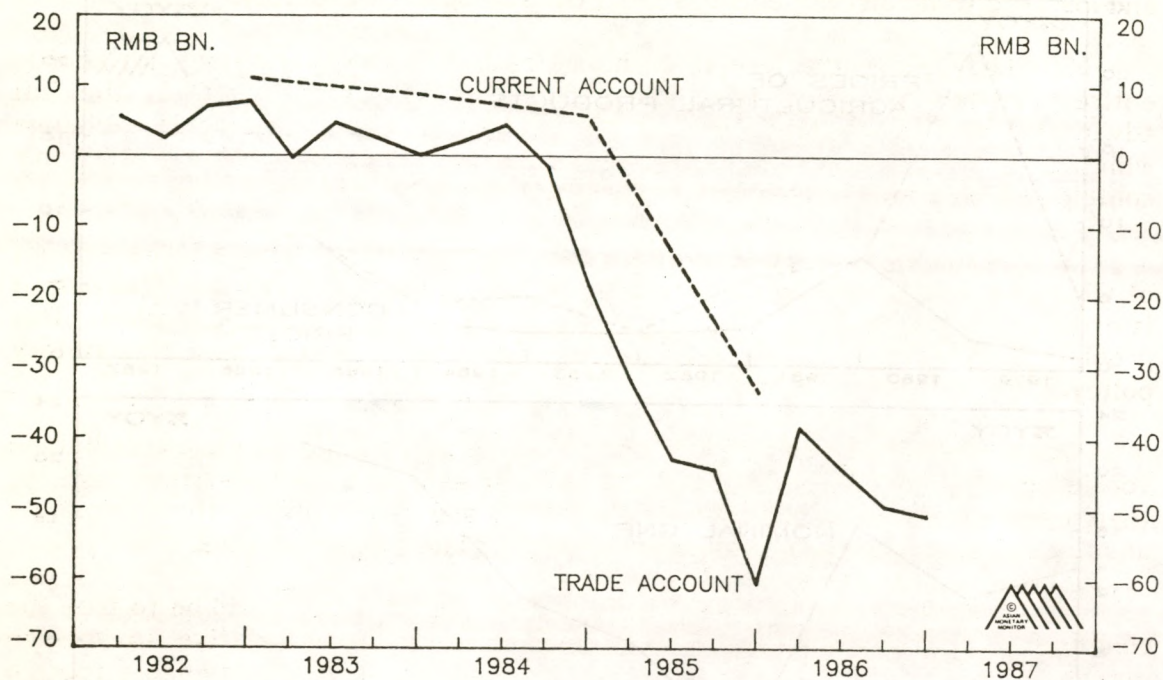
We have also included a chart (Chart 4) on Hong Kong's re-exports to China (Chinese imports) and re-exports from China (Chinese exports) because these data are more likely to be reliable than China's own statistics on exports and imports. Unfortunately, one must be extremely careful in interpreting these numbers since such a large part of Hong Kong industry has successfully integrated into Canton Province's low labor cost economy. Thus, Hong Kong re-exports from China may be qualitatively different from Chinese exports from other areas. They will on average have lower Chinese value added. With these caveats in mind, the chart shows very high rates of re-exports from China. This contrasts with the sharp fall off in Chinese exports overall, shown on Chart 3.

The Chinese have found it difficult to make effective use of their foreign exchange when spent on imports. Since economic agents are not facing the constraint of the profit motive, China wasted a large fraction of its foreign exchange when it increased its imports dramatically in 1984. These imports were highly valued from the standpoint of those who were in charge of ordering them, even though the items were of low value in terms of adding to national wealth and output. Since future output and wealth would not necessarily accrue to managers as a result of their 'correct' decisions on imports, managers

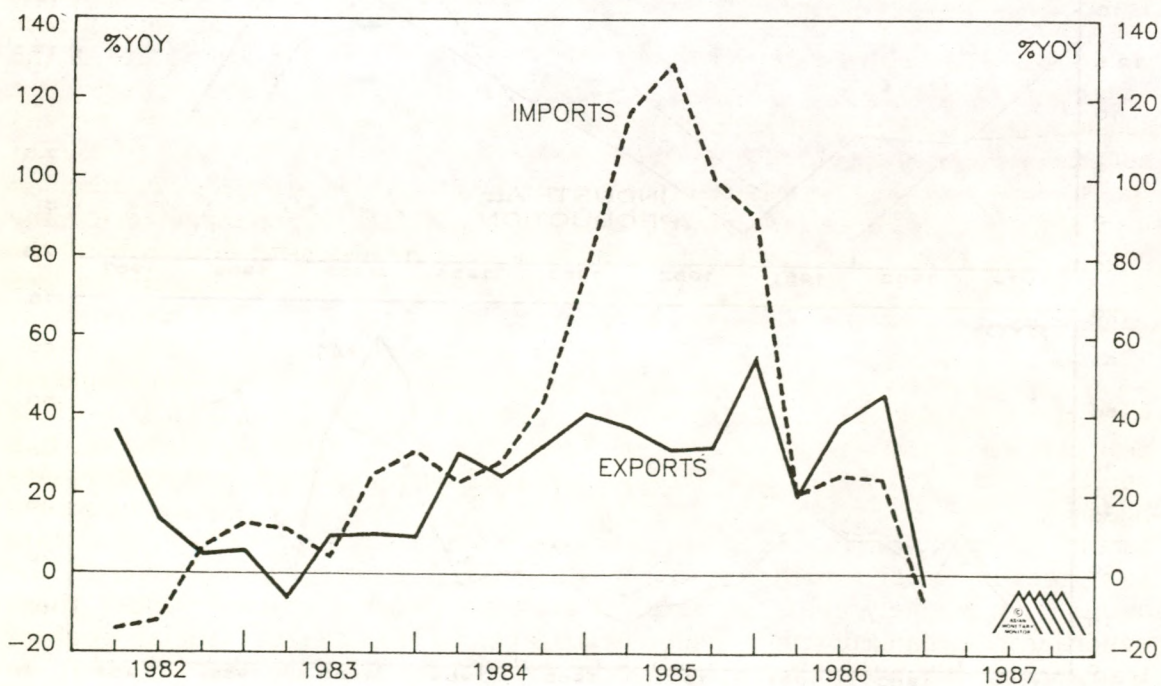
CHINA: CHART 1
MONEY, OUTPUT AND PRICES



CHINA
CHART 2: CURRENT ACCOUNT AND TRADE ACCOUNT



CHINA
CHART 3: EXPORTS AND IMPORTS GROWTH



naturally ordered what would make them better off personally. Once again, giving managers more freedom, without accountability to the owner for profit and loss, led to incorrect decisions from the standpoint of society.

Similarly, since the foreign exchange earned from exports does not accrue entirely to the exporting firm, the exporter is not able to extract the full advantage from his exports. In fact, the proportion of earned foreign exchange which can be retained by exporting firms was changed recently and this contributed to the fall in exports in the last quarter of 1986.

With export growth falling and industrial production rising a large amount of China's unsold output appears to be going into inventory build-up. This output is either very low in quality or is of products for which there is no market. This problem and its implications are discussed more fully in the section on monetary policy.

All of the foreign firms involved in joint ventures in China have complained vociferously about the availability of foreign exchange to repatriate back to their overseas parent firms. These complaints are in addition to the complaints about bureaucracy, delays, and overcharging for labor and materials.

Given that foreign exchange is so scarce, one solution would be to free the renminbi. The renminbi would then tend to that value relative to foreign currencies which would equate its supply to demand. This would enable foreign firms to at least be able to pay some dividends. Unfortunately, however, the lack of a profit motive, and state ownership of industrial enterprises, makes this straightforward solution impossible. Let us, for a moment, assume that there was a freely floating exchange rate. In this case, presumably, local factory managers could buy and sell foreign exchange. For example, they would purchase it if they needed foreign money to buy needed capital goods which they could not obtain domestically. If they made a mistake on the exchange rate, and overpaid, they might go bankrupt and thus the manager and the factory owners would be penalised for the incorrect decision. But, in China the state is the owner and it has in the past supported firms which have losses with greater subsidies. The state does not have ready access to foreign loans, nor is it easily able to mobilize savings domestically. At the margin, therefore, it would pay for the subsidy through the creation of money, which would cause the renminbi to lose value and thereby tend to ratify the price the factory manager originally paid. Therefore, without control over the subsidy to industry, and without the possibility of an independent monetary policy, the renminbi would tend to lose value rapidly.

The authorities have tried to address this issue and to discipline managers with the creation of a bankruptcy law. It is not known how this will work in practice, but there is a practical problem. When a bankruptcy occurs in a capitalist country, the former owner sells the assets to someone else and takes his loss. The firm's creditors take the proceeds in exchange for relinquishing further claims. But in China, the state owns everything. Therefore, if a state firm goes bankrupt, another state owned firm is the only possible buyer of the assets. It is likely that the state is also the major creditor. Under these conditions, a bankruptcy is unlikely to achieve the correct social goal of transferring the ownership of resources from those who are less efficient, to

those who are more efficient, at managing them.

Money Supply

As we mentioned previously, China's production rose by a respectable amount in 1986. However, export growth decelerated and in the last quarter of 1986 exports fell relative to the fourth quarter of 1985. In addition, anecdotal evidence suggests that this additional production remains largely unsold, and that as a result there is an inventory build-up. This probably has also been a factor contributing to the increase in China's budget deficit. The Asian Wall Street Journal (10/2/1987) reported that the losses of those state factories which had losses (state factories overall have profits) increased in 1986 for the first time since 1982. One sixth of China's factories are losing money. With China's under-developed bond market, part of the deficit is necessarily financed with money creation.

M1 growth surged to 49.8% year-on-year in the third quarter of 1986, while M2 growth was 44.8% and currency in circulation increased by 18.3% for the same time period. The increase in M2 relative to currency is an indication that the banking system is becoming somewhat more developed. However, there is still too much money in circulation relative to the level of nominal income.

We estimate that there is a repressed one-time change in the price level of at least 50%, and possibly as much as 200%, which is masked by the price controls used throughout the economy. First, in the middle of January 1987 the black market price of the renminbi was Rmb. 5.5 to Rmb. 6 per US\$. This was 48% to 62% greater than the fixed exchange rate of Rmb 3.71 per U.S.\$ current at that time. The black market price of the Foreign Exchange Certificate (FEC) Rmb. was Rmb. 1.4 per FEC, or 40% greater than the fixed price of one to one.

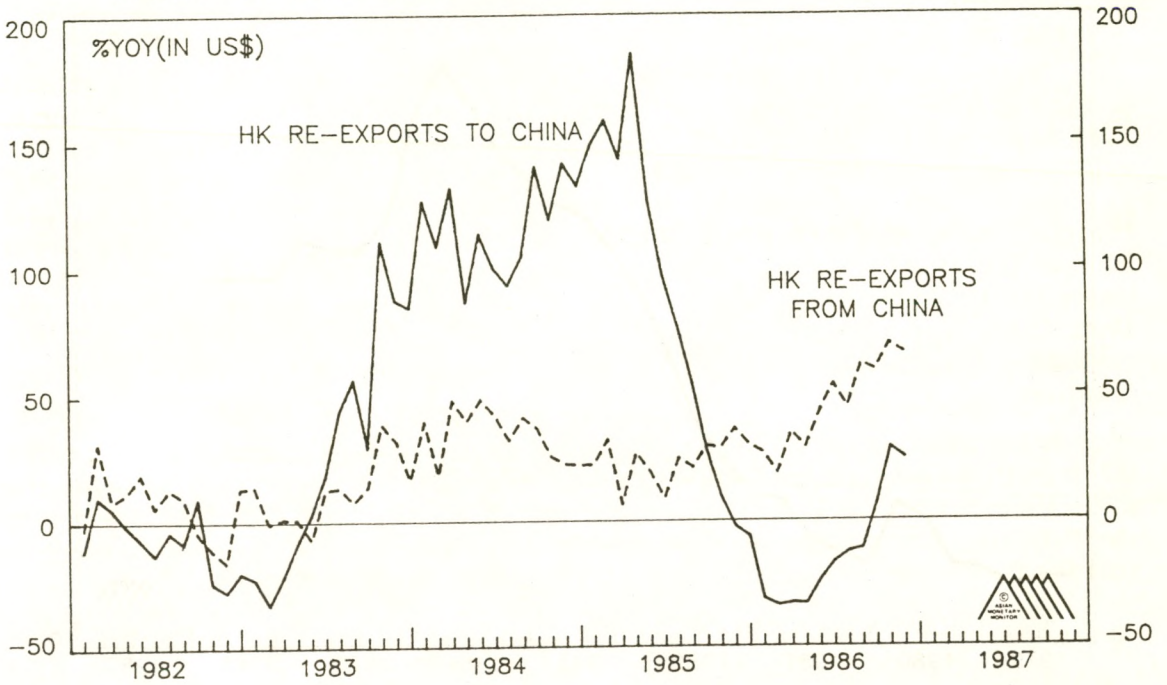
The following table uses a cross-sectional approach to arrive at an even more pessimistic conclusion. We have taken eight countries, including the PRC, which have a similar level of per capita GDP, according to the World Bank, and also report monetary statistics in International Financial Statistics. In the case of the PRC, data considerations dictated using national income instead of GDP. Since national income for similar countries is 10% below GDP, and this figure enters the denominator of the key statistic in the table, we must make an adjustment.

<u>COUNTRY</u>	<u>M2/GDP</u>	<u>PER CAPITA GNP</u> (1984 dollars)	<u>OBSERVATION YEAR</u>
Madagascar	.188	260	1984
Benin	.252	270	1983
Rwanda	.127	280	1983
PRC	.642	310	1986
Kenya	.284	310	1985
Sierra Leone	.206	310	1984
Haiti	.294	320	1984
Ghana	.116	350	1984
U.S.	.626	15390	1985

Note: The average M2/GDP for the seven less-developed countries other than China is .210.

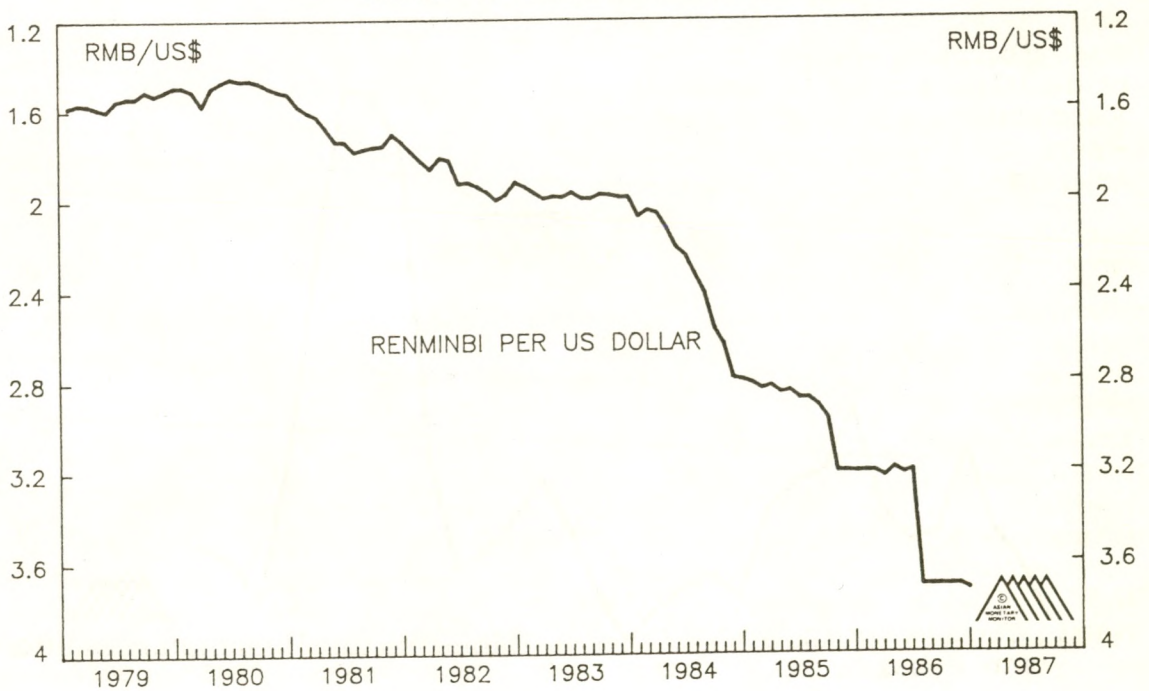
CHINA

CHART 4: HONG KONG RE-EXPORTS FROM AND TO CHINA

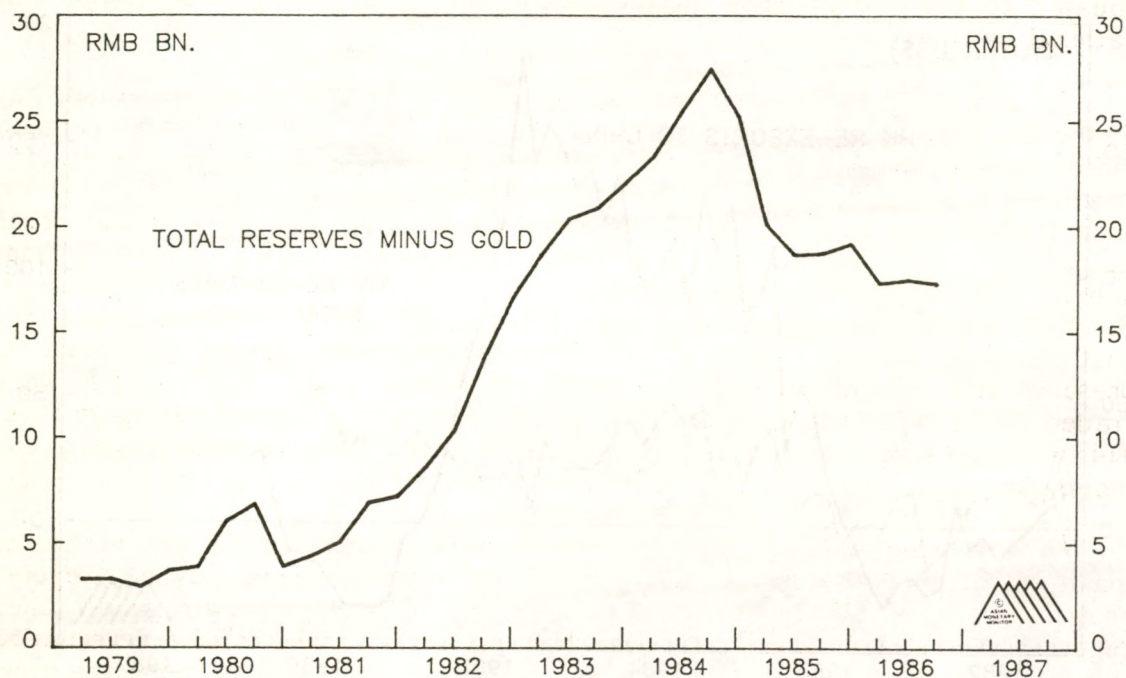


CHINA

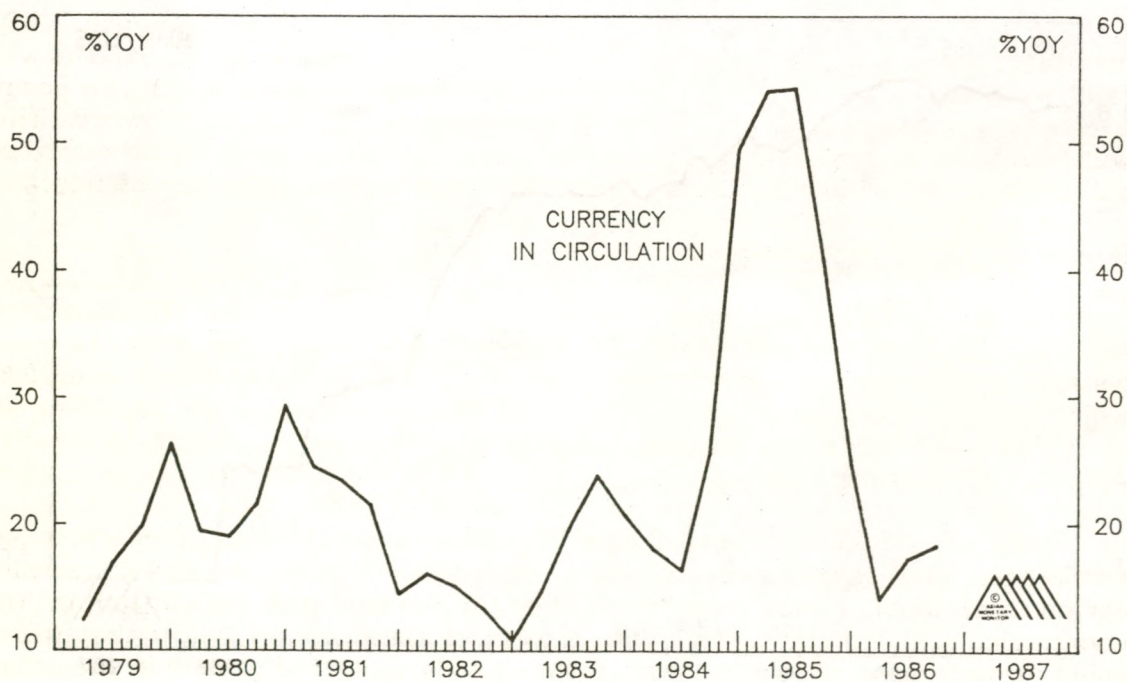
CHART 5: EXCHANGE RATE



CHINA
CHART 6: FOREIGN RESERVES



CHINA
CHART 7: CURRENCY IN CIRCULATION



The figure for the PRC above has been adjusted by 10% for the difference between national income and gross domestic product. In addition, it has been updated to the end of 1986 on the assumption of a 20% growth in nominal national income.

It appears that China's money supply relative to GDP is greater than that of the United States. This is in spite of the fact that the United States is much more highly developed financially. When comparing the same figure for countries at a similar stage of development, we see that the Chinese have more than three times as much money in circulation as the average for the other countries. Of course, one must be wary when making cross-sectional comparisons such as this, especially for countries at this stage of development. But here the order of magnitude of the difference in money holdings is so great that observers cannot dismiss it out of hand. This extra money will make its presence felt somewhere in the economy. It implies that if the renminbi were traded freely it would depreciate sharply relative to the current exchange rate. This would be true even if the vicious circle running from enterprise losses to the money supply to the exchange rate did not occur.

The sharp drop in China's reserves growth has caused the authorities to make use of central planning controls to force imports lower. However, export growth has fallen along with imports. The drop in export growth, when taken together with the excess money in circulation, argues in favor of a devaluation this year and a decrease in the subsidies on various goods, steel being the most obvious. However, the recent change of political tone in the country, and the ascendancy of the faction of the Communist Party which is in favor of strong central planning, lessen the probability of a devaluation and subsequent price increases. The complaints which the central planning faction of the Communist Party have been responding to include inflation and high prices for goods in the unregulated markets.

If there is no devaluation and no price increases, China's economy will inevitably suffer during 1987. Growth will be lower than otherwise, exports will fall, and imports will also have to be reduced unless reserves are drawn down. Eventually, probably as a result of the government deficit, the state-owned firms will have to stop producing goods for inventory. If China devalues, other prices will certainly have to be adjusted. This adjustment will be politically difficult.

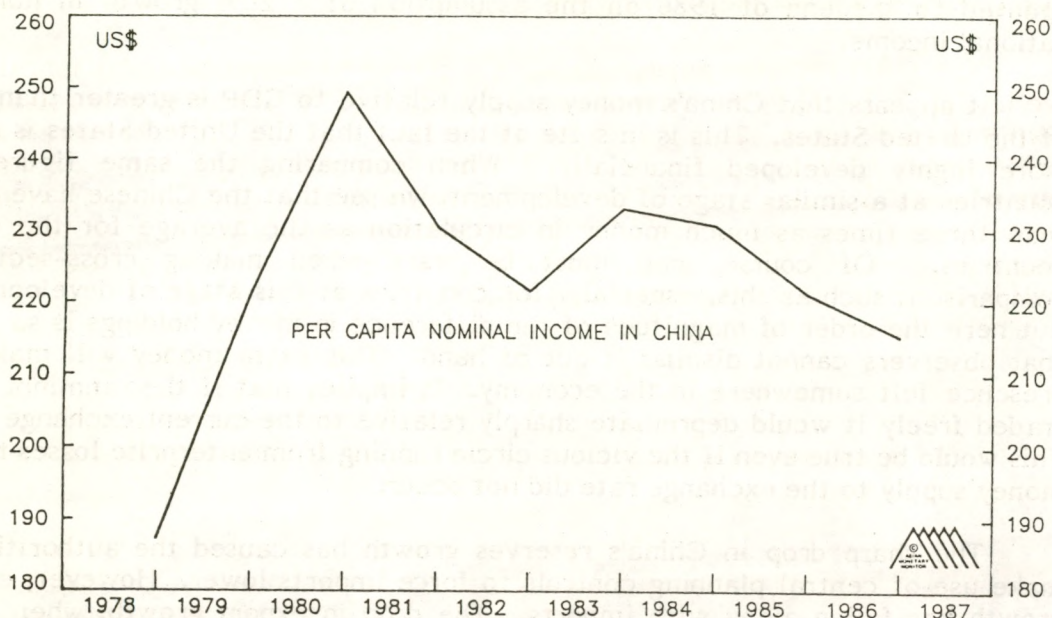
Population Movement Control

China has a great number of controls on the movement of people. A household registry is maintained in each locality and if a person wants to move he has to obtain the permission of his original work unit and also the unit to which he wants to transfer. This is difficult to do. With the state providing all of the jobs and also all of the housing and medical benefits, moving to the city without changing the registry carries a high risk economically.

This has slowed the movement of people to the city. The government has encouraged the development of rural industries in order to absorb surplus agricultural labor. However, the policy of keeping the population in the countryside will inevitably lower the growth of the economy below that which could be achieved should free migration be allowed. The growth in the urban

CHINA

CHART 8: NOMINAL INCOME PER CAPITA



areas of China during the period of rapid economic development has been 5 percent annually, which is roughly equivalent to the experience of Korea and Taiwan. However, recent projections see a significant decline in urban growth in the future.

There are many economies of scale to industry and commerce to be derived from people coming together in cities to work and trade. Current Chinese regulations effectively prohibit these advances from occurring. The government's problem is that the planners have no way to plan this migration, nor to provide the essential services that those migrants would require, such as housing, sewage and water. Private sector construction is not allowed. Nor will the government countenance the development of shanty towns as an interim solution to the housing problem. Instead, the government is forced into the situation where it is fostering income inequality and low growth by preventing the population from migrating. If China wants to develop as rapidly as its neighbours have done, it will have to change its migration restrictions.

Conclusion

The Chinese economy grew at a respectable rate during 1986. Unfortunately for future growth prospects it appears that the recent political turmoil will lead, at least in the short-run, to a slowdown in the pace of economic reform. Until the end of 1986, China was undergoing a peaceful, gradual transition from a state-planned economy to one governed by free market forces. However, the inherent contradictions have led to distortions and incorrect decisions on the part of economic agents. The authorities although aware of problems, have been prevented by socialist ideology from implementing further liberalizations necessary to correct the country's economic decision making process. As a result of the government deficit and chaotic credit creation, there has also been an unhealthy increase in the money supply, which

should have ramifications for the exchange rate and prices. To the extent that the effects are bottled up through price controls, shortages will develop or translate into future money creation.

The rural reforms appear to have a strong backing and to be functioning well. This is because the fifteen year lease allows the peasants to act as if they own the land. The majority of the structural problems have occurred in the urban areas. The state enterprise managers have been given increased freedom but without a concomitant increase in responsibility. It is unlikely that this problem will be solved in the near term. If the recent reforms, in spite of being halfway measures, are judged a failure and reversed, it is likely that the fault will have rested with the ownership structure of the enterprises.

REPUBLIC OF KOREA: MARKET OPENING POSES A MONETARY DILEMMA

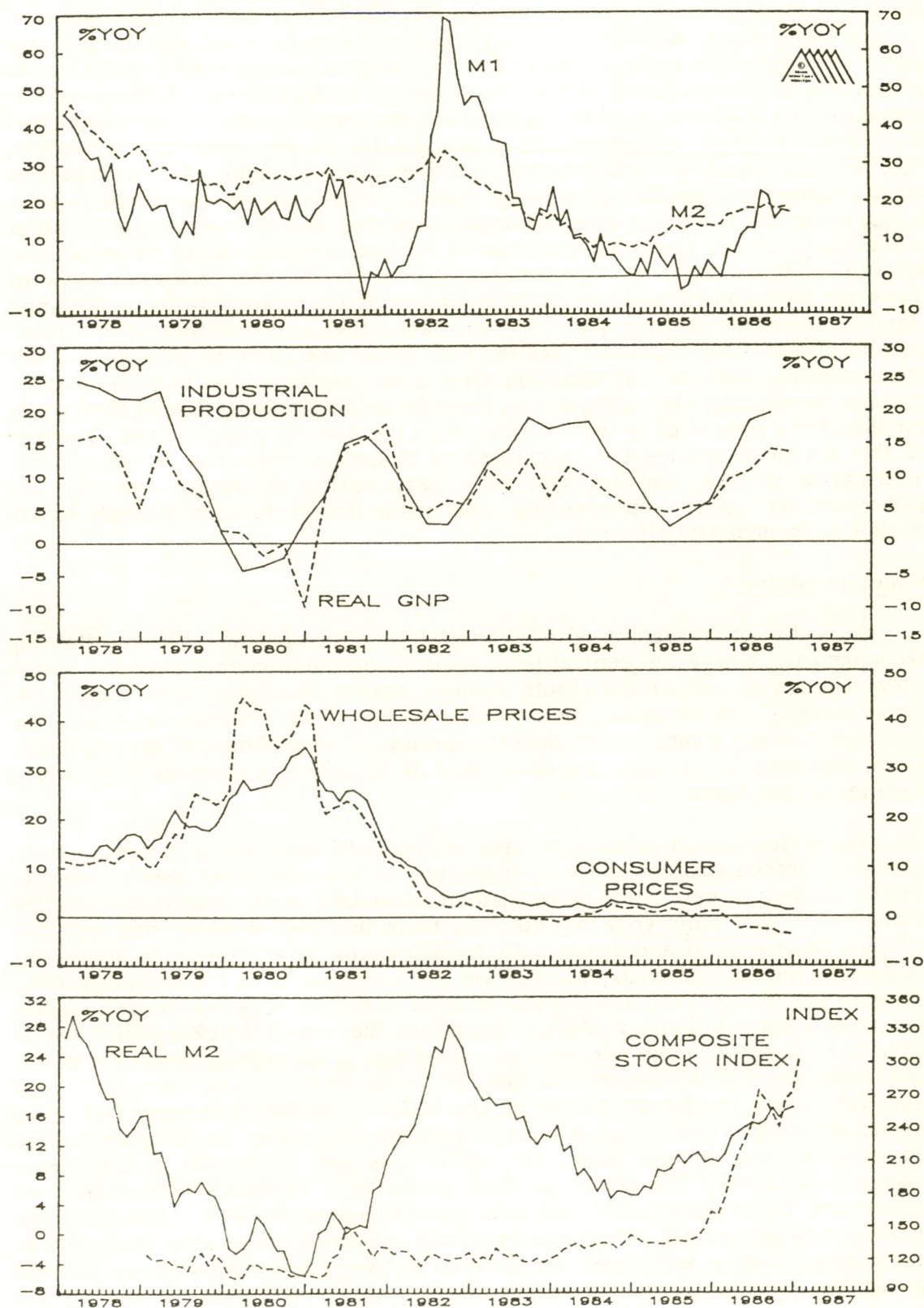
Introduction

During 1986 the Seoul composite stock exchange index rose by 67% in domestic currency terms, making it the best performing bourse on the Pacific Rim after the Philippines. The rise was closely related to the sharp build-up in liquidity resulting from the \$4.6 billion surplus on the current account of the balance of payments - only the second surplus in the last 20 years. Despite active attempts by the Bank of Korea to sterilise the liquidity build-up in the second half of the year - via the issue of currency stabilisation bonds, the use of the sterilisation account and the early repayment of foreign obligations - M2 climbed by an average 17.5% over the year. Although this was within the 16%-18% target range, growth accelerated towards the year end, rising to 19% year-on-year in December and 22% in January.

1987 will be a crucial year for Korea's financial markets. Not only does it mark the first year of the sixth five year economic plan, a key objective of which is to build on the current account surplus achieved last year and transform Korea from a capital importing to a capital exporting country, but also the third phase of the process of opening Korea's equity markets to foreign participation. In this respect, in the annual presentation to President Chun, on 28 January, Korea's Minister of Finance announced a plan that would allow direct foreign portfolio investment. The first two stages of the opening of Korea's capital markets involved the establishment of five onshore investment trusts and one offshore trust in New York (with a second one currently being established in London) and the issue for the first time, in late 1985, of Euro-convertible bonds by Korean corporations. Politics aside, the extent to which the authorities implement their broad commitment will depend upon how confident they feel about their ability to effectively sterilise any foreign inflow that may occur. Replacing loan capital with portfolio investment may be a long-term objective of the Korean authorities which would ultimately make for a more stable economy, but in the short-term it could pose an inflationary problem.

In contrast to the other three Asian NICs of Taiwan, Singapore and Hong Kong, Korea had a poor record on the inflation front in the 1960s and 1970s. Rapid economic growth was accompanied by steadily rising inflation, which officially peaked at nearly 30% in 1980 following the second oil price hike in 1979. In theory the fixed exchange rate of the won acted as a brake on monetary expansion. In practice both monetary and exchange rate policy were procyclical. When sluggish export growth and growing current account shortfalls threatened to slow economic growth, devaluations of the won were undertaken, imparting considerable instability to monetary growth. Since the adoption of a 'managed float' for the won in 1980, and with a firmer commitment to monetarism the situation has reversed. Between 1981 and 1985, spanning the first four years of the Fifth Five Year Plan, steady economic growth was combined with declining inflation and narrowing current account shortfalls as the rate of monetary expansion slowed (Chart 1).

THE REPUBLIC OF KOREA
 CHART 1: MONEY, OUTPUT AND PRICES



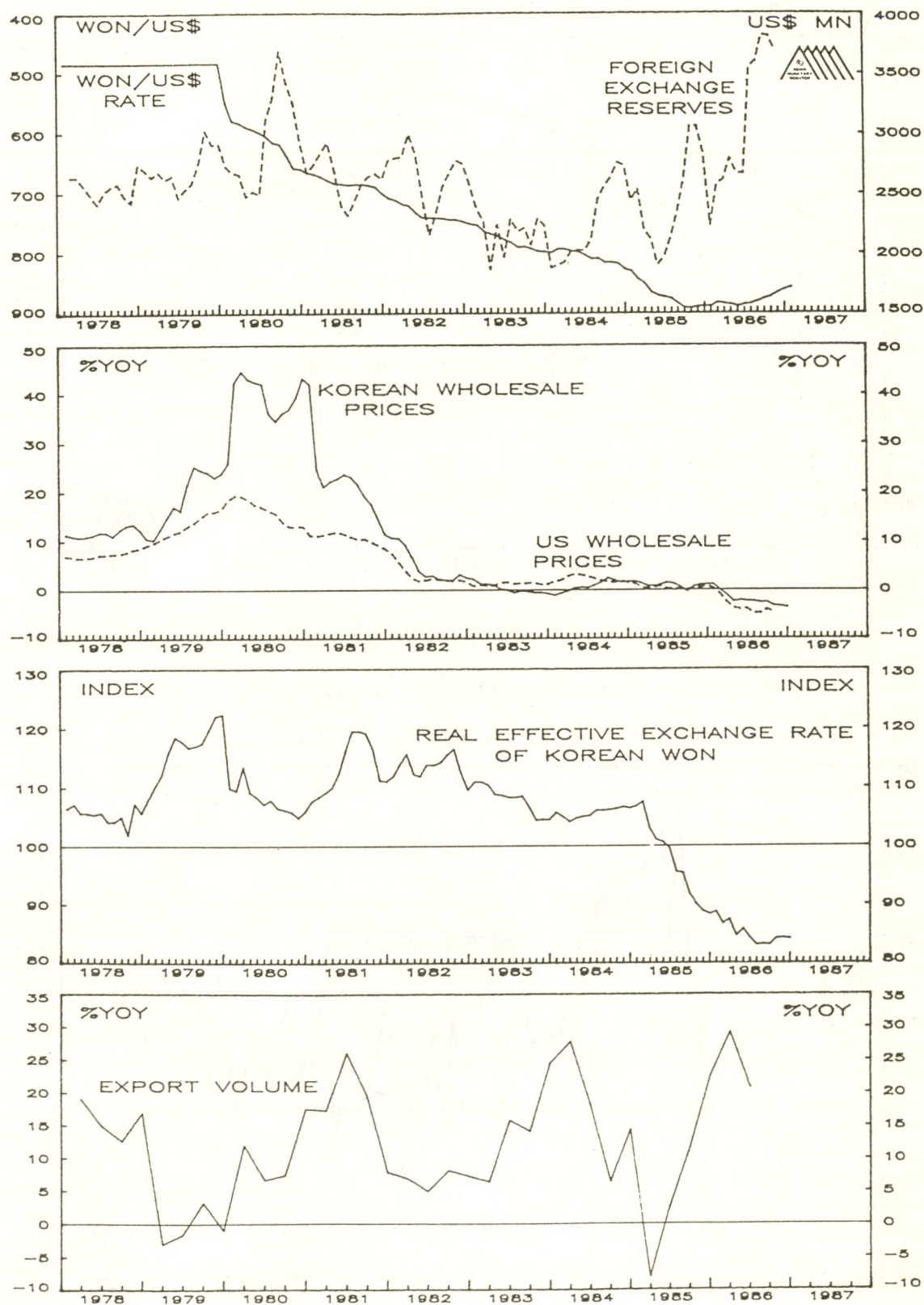
However, the move into current account surplus last year added an extra dimension to the authorities' problems in curbing money supply growth. The failure to contain money growth, despite the early repayment of \$2.5 billion of foreign obligations, highlights the difficulties the authorities will face in the event of large scale capital inflows should foreigners be allowed to build up the proportion of Korean assets in their portfolios to desired levels. A compensating relaxation on the restriction of capital outflows would be one solution, but given the current political environment this is unlikely. In this respect, it is perhaps notable that Japan, on whose economic development strategy Korea's has been closely based, only abolished exchange controls in 1980, some twelve years after it had made the transition from a capital importing to exporting nation. Instead the authorities are likely to continue to rely on a combination of amortising foreign debt and internal sterilisation. However, the contradictions between monetary base control and administered exchange and interest rates, as well as a rigidly controlled banking system which lacks the sophistication of the other sectors of the economy, mean that the authorities are likely to struggle to meet the monetary targets. In addition, they may also be faced with a problem common to all countries deregulating their financial markets, that of identifying the distorting impact of re-intermediation on the monetary aggregates. The rest of this article examines the techniques of monetary control in Korea and the restrictions on the banking system, in attempting to assess how far the authorities will go in implementing their commitment to open Korea's equity market to foreign participation.

Monetary control

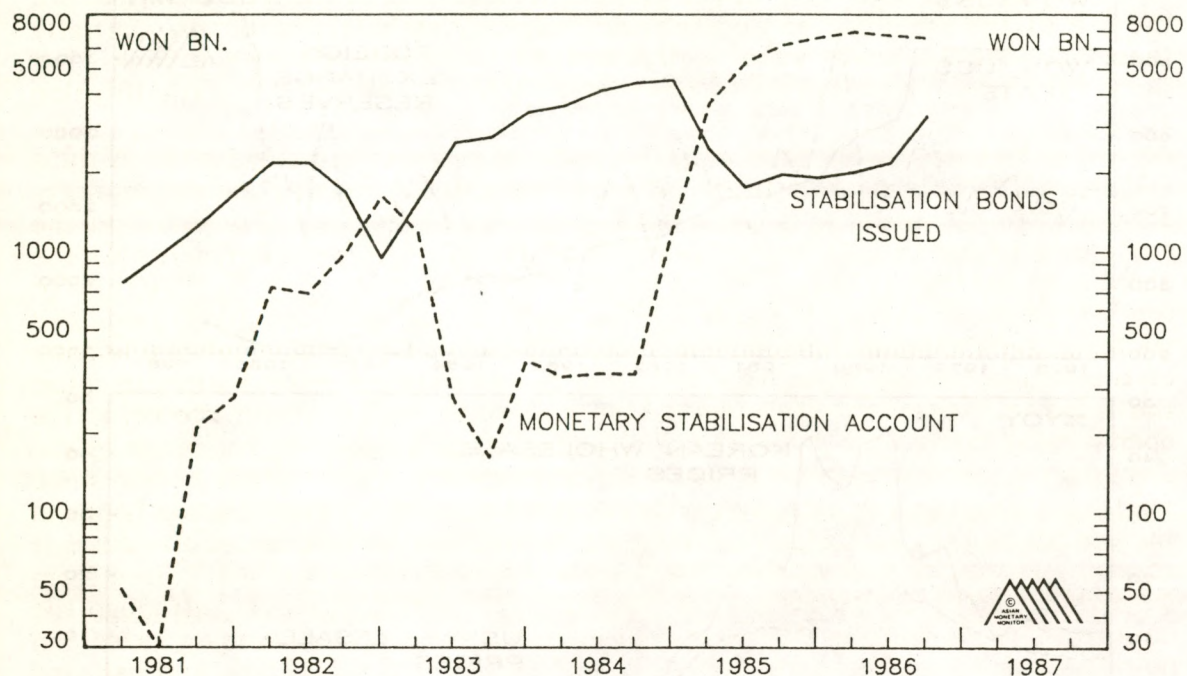
In a financial system with no exchange controls and a freely floating exchange rate, where the central bank operates on the monetary base and allows interest rates to reflect the result of these actions, exchange rate movements should reflect the monetary policy stance. In short interest rates and the exchange rate are a function of monetary policy. Korea's financial system meets these requirements in only one area, that is in having a Central Bank which operates on the monetary base.

While the Korean authorities have actively operated on the monetary base, neither interest rates nor the exchange rate for the won have been allowed to reflect market forces. Both have instead continued to be geared towards the promotion of economic growth. Further, there has been a major contradiction between the supply of and demand for foreign exchange as proxied by underlying changes in the foreign exchange reserves and movements in the exchange rate. Between the end of 1981 and the end of 1985 Korea's foreign exchange reserves rose from US\$6.9 billion to US\$7.8 billion, but the won fell 21% against the US dollar (see Chart 2). The currency was in effect progressively devalued by the authorities so as to supplement an already inbuilt advantage of lower unit wage costs (which are the lowest of any of the NICs). Although the impact of rising foreign exchange reserves on domestic liquidity was offset by the sterilisation activities of the central bank, the policy has led to strains in US-Korean economic relations. The Economic Plan allows for a 3% revaluation of the won against the dollar during 1987, but a larger rise is probable in a bid to stave off protectionist pressures. If as seems likely this becomes a pattern in future years, then Korea will need to achieve future competitive gains through favourable price performance rather than exchange rate adjustment. This will

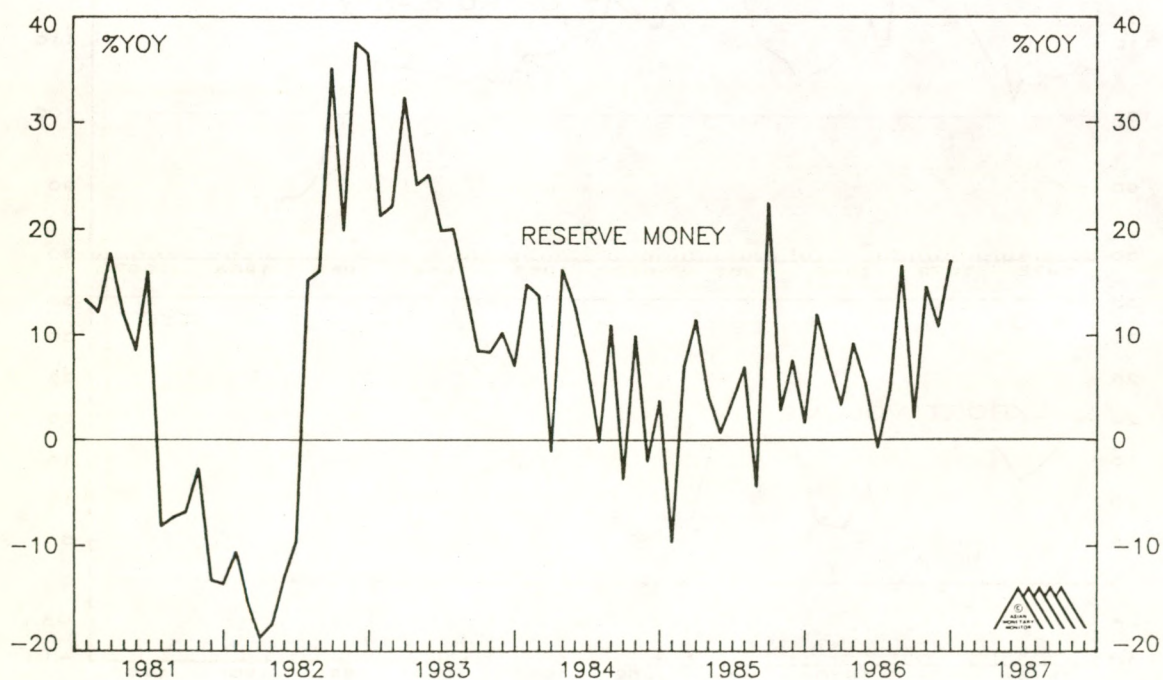
THE REPUBLIC OF KOREA
CHART 2: EXCHANGE RATE POLICY



THE REPUBLIC OF KOREA
CHART 3: BANK OF KOREA STERILISATION ACTIVITY



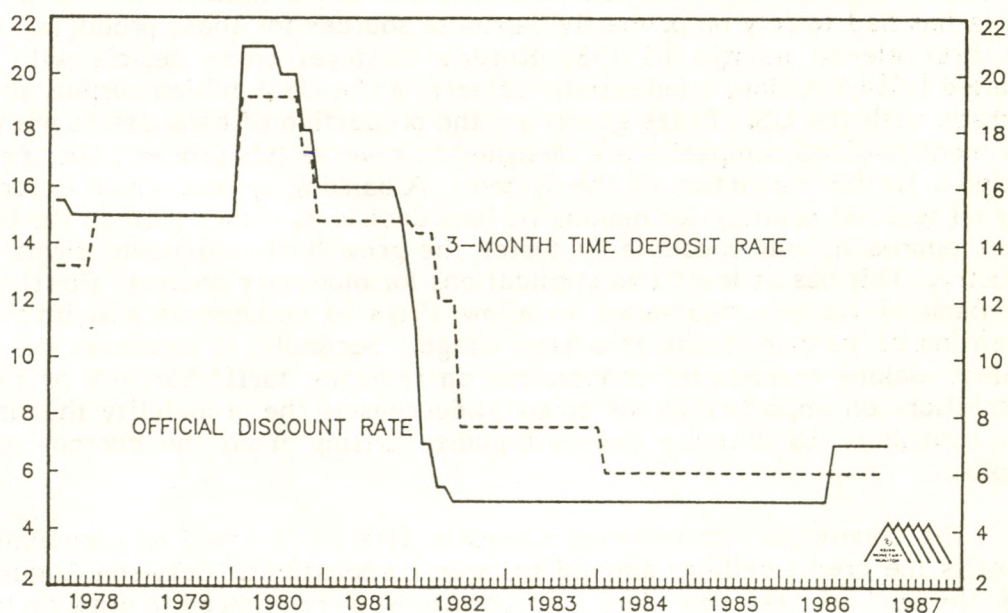
THE REPUBLIC OF KOREA
CHART 4: RESERVE MONEY



place more pressure on the authorities to control money growth.

The Bank of Korea's primary indirect instruments of monetary control are the use of the stabilisation account and monetary stabilisation bonds. Initially these stabilisation bonds were administratively allocated among the banks, but since 1973 they have been auctioned through a tender system. The stabilisation account was established in 1967, and requires that the deposit money banks deposit with the Central Bank a certain fraction of their loanable funds. A third instrument, the foreign equalisation bond, designed to absorb excess liquidity arising from balance of payments surpluses, was added early this year. In the past, use has also been made of variations in the reserve requirements of the deposit money banks, though this option has not been used recently. The reserve requirements of both time and savings and demand deposits have remained unchanged at 4.5% since September 1984. Direct credit ceilings on the lending of the deposit money banks have also been a feature since 1977, mainly because the relatively undeveloped state of Korea's money market has made effective open market operations difficult to conduct. Chart 3 shows the use made of the sterilisation account and the issuance of monetary stabilisation bonds since 1981. It highlights the particularly heavy issue of currency stabilisation bonds in the second half of last year in the effort to sterilise the impact of the current account surplus. Simultaneously the central bank's discount rate was raised from 5% to 7% on 10 July to discourage domestic borrowing. However, although the uniform rate on bank lending was abolished in 1984 and bank lending rates can now be autonomously determined within a range of 10% to 13.5%, and call and commercial paper rates were deregulated in 1984 and 1985 respectively, deposit rates are still strictly controlled by the authorities and only infrequently changed. Interest rates on three month time deposits have remained unchanged at 6% since January 1984, while last year's adjustment to the discount rate was the first since March 1982 (see Chart 5).

THE REPUBLIC OF KOREA
CHART 5: INTEREST RATES INFLEXIBLE



The objective of Korea's interest rate policy has been and remains the mobilisation and provision of cheap finance to domestic industry. The current interest rate structure is oriented towards this objective. Although current real interest rates (prime lending rate) are 8%-9%, acting as an incentive to individual savings but a deterrent to individual borrowing, they do not pose an undue burden on industry given the return on capital. A survey of returns on capital of US firms operating abroad during 1984, published by the US Department of Commerce, showed an over 40% return in Korea.

Banking regulation

The controls on interest rates form part of, and must be seen within the context of, the heavy regulation which already exists within the banking system. While recognising the extent of the distorting impact of these controls the authorities have proceeded cautiously with deregulation. Although the five major deposit money banks passed into private hands between 1981 and 1983, and there are plans to privatise all remaining government funded specialist banks by 1988 and put them on a competitive footing with the deposit money banks, the government still wields effective control over the banking system. The heads of the five major deposit banks are appointed by the government and most of the staff were trained in a state run banking system. Guidelines aimed at increasing the proportion of bank assets with small and medium sized firms are also in force, as well as de facto controls on the sectoral distribution of bank assets. In recent remarks the governor of the Central Bank noted that "to heighten the effectiveness of the nation's scarce capital resources the central bank will strictly control the extension of lending facilities to non-productive areas as much as possible".

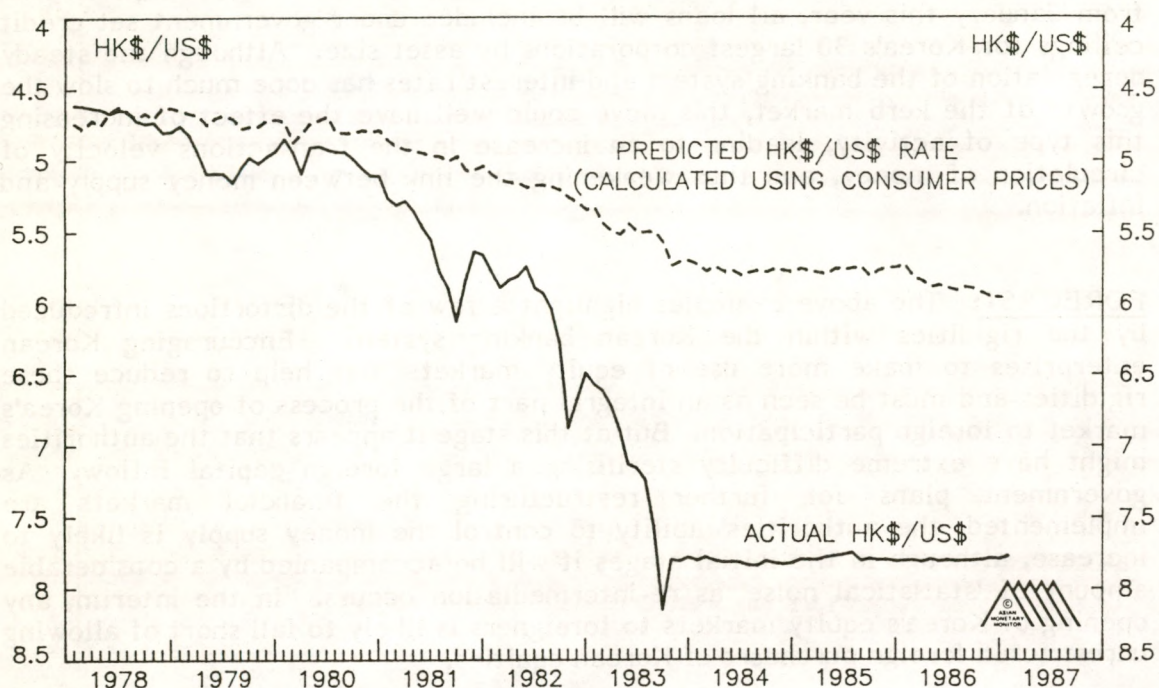
The effective distribution of credit according to national priority has undoubtedly contributed to the rapid growth in the manufacturing sector and hence to Korea's economic development. But it has also led to the heavy concentration of economic power in the hands of the chaebol, and the relatively underdeveloped state of Korea's intermediate goods industries. As a result, Korea has had to rely on primarily Japanese sources for these products. During the first eleven months of 1986 Korea's bilateral trade deficit with Japan totalled US\$4.9 billion, substantially offsetting the US\$6 billion surplus achieved in trade with the US. Rules governing the proportion of bank assets with small and medium-sized companies are designed to reverse this process, but are likely to add a further distortion to the system. A banking system which is forced to rely on sectoral priority for making its loan decisions, rather than on the balance sheet approach, will undoubtedly foster the growth of inefficient firms within industry. This has at least two implications for monetary control. Firstly, given the Bank of Korea's reluctance to allow firms to collapse it will involve the extension of further credit at a later stage. Secondly, it increases the stakes against making meaningful concessions on reducing tariff barriers or relaxing restrictions on imports into the country, decreasing the probability that imports can contribute to draining excess liquidity arising from the current account surplus.

The counterpart to ensuring adequate finance to small and medium-sized firms is the credit ceilings applied to large corporations. Between August 1985 and the end of last year large corporations were allowed to draw on lines of

credit from banks for capital investment and export promotion outside the ceilings set by the Bank of Korea. However, the rapid build-up in liquidity caused the authorities to revise this scheme. Under the new scheme, operational from January this year, all loans will be included under government set credit ceilings for Korea's 30 largest corporations by asset size. Although the steady deregulation of the banking system and interest rates has done much to slow the growth of the korb market, this move could well have the effect of increasing this type of activity, leading to an increase in the transactions velocity of circulation of money, and thus weakening the link between money supply and inflation.

FORECAST: The above examples highlight a few of the distortions introduced by the rigidities within the Korean banking system. Encouraging Korean enterprises to make more use of equity markets may help to reduce these rigidities and must be seen as an integral part of the process of opening Korea's market to foreign participation. But at this stage it appears that the authorities might have extreme difficulty sterilising a large foreign capital inflow. As government plans for further restructuring the financial markets are implemented, the authorities' ability to control the money supply is likely to increase, although in the initial stages it will be accompanied by a considerable amount of 'statistical noise' as re-intermediation occurs. In the interim, any opening of Korea's equity markets to foreigners is likely to fall short of allowing unrestricted foreign purchases of Korean equities.

HONG KONG: MONEY SUPPLY GROWTH AND INFLATION INCREASE

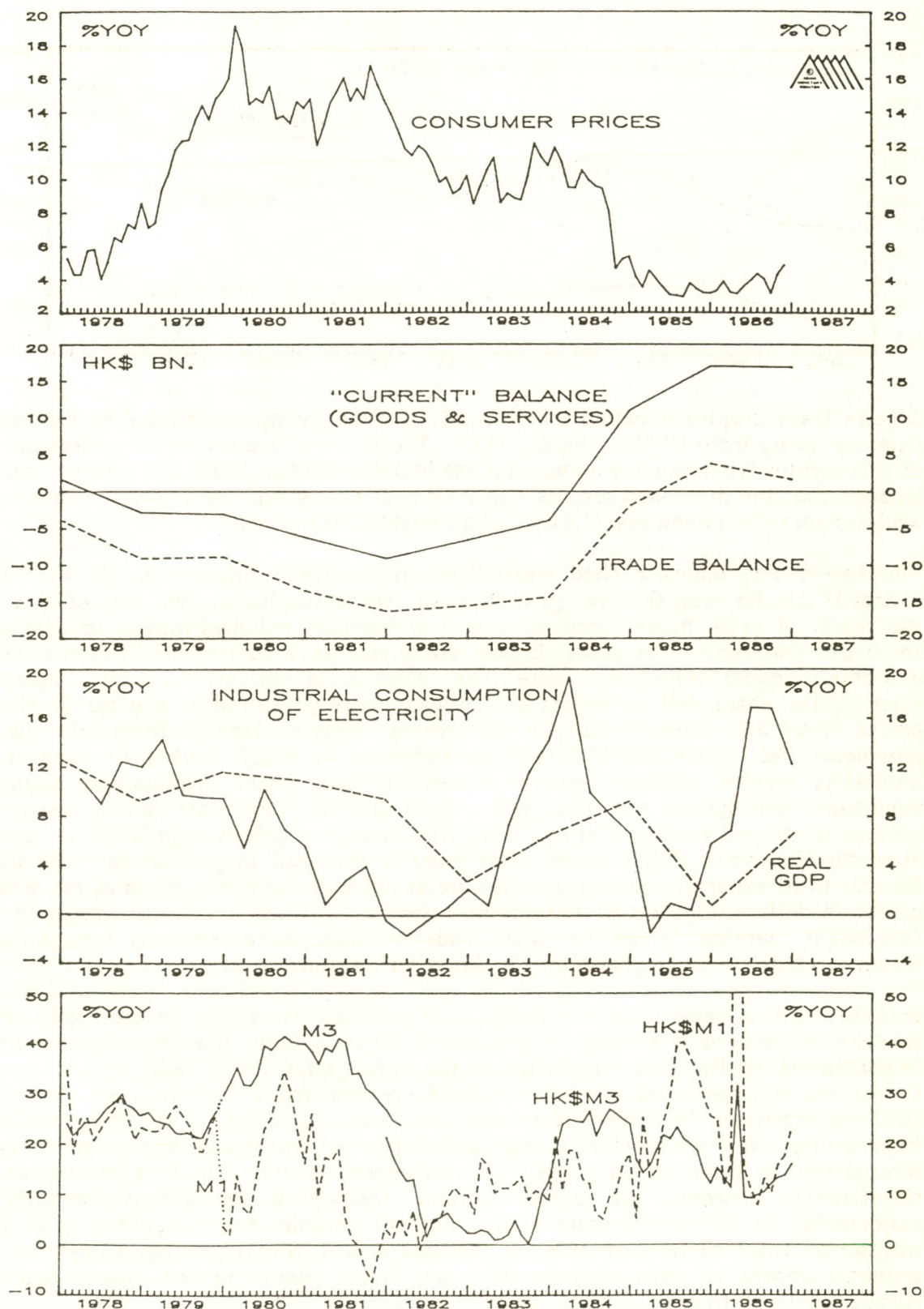


Since October 1983 the Hong Kong dollar has been linked to the US dollar via a link rate of 7.8 between US\$ deposits and HK\$ banknotes. Recently, the Hong Kong dollar has been trading at a premium to the link rate due to outside speculation that a revaluation may be forced by United States political pressure. The speculative capital inflow helped to raise the growth rate of HK\$M3 to 16% for the year ending in December. This represents an acceleration from the low of 9.2% growth reached in June 1986.

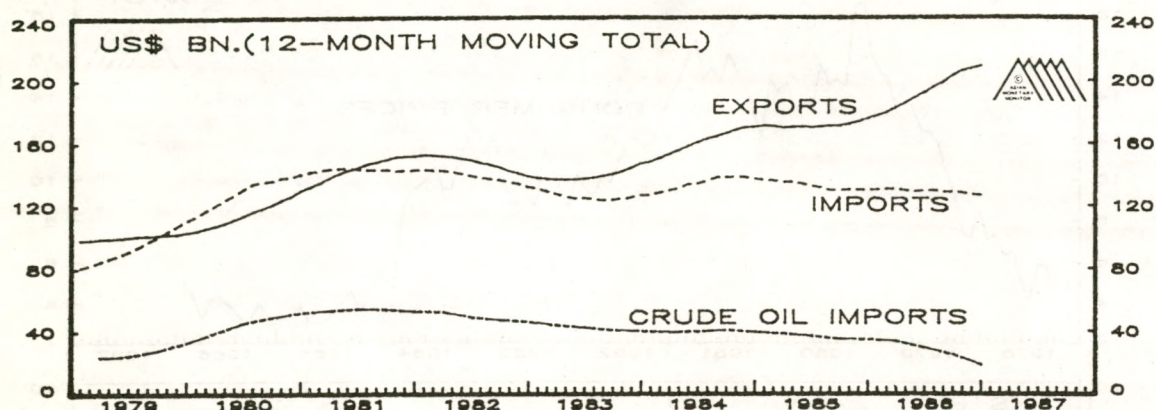
Presumably, political pressure is perceived to have occurred because the HK\$ fell in value along with the US\$, leading to an 'unrealistic' exchange rate. Of course, with free flows of goods, services, and capital, a disequilibrium exchange rate will be corrected automatically. The balance of payments will be in surplus, money will be created, banks will increase lending, economic activity will increase, and this will lead to a rise in the internal price level relative to the external (in this case, US) price level. This process has been occurring over the course of 1986 as can be seen above from the 3.8% fall in the predicted HK\$/US\$ exchange rate. Consumer price inflation in Hong Kong reached 4.8% for 1986.

GDP growth is officially estimated to have been 8.7% in 1986. With domestic exports up 18.6% year-on-year, this growth was export-led. If Hong Kong follows past experience, 1987 should see a greater contribution to growth from the domestic economy. With unemployment falling to 2.2% in December, the major medium term worry is that this growth will translate into increases in real wages which cannot be maintained in the long run. Either a slowdown in the US economy caused by Federal Reserve tightening, or protectionism, would hurt Hong Kong even more than usual if real wage increases had to be reversed.

HONG KONG MONEY, OUTPUT, TRADE AND PRICES



JAPAN: TRADE SURPLUS SET TO NARROW SIGNIFICANTLY

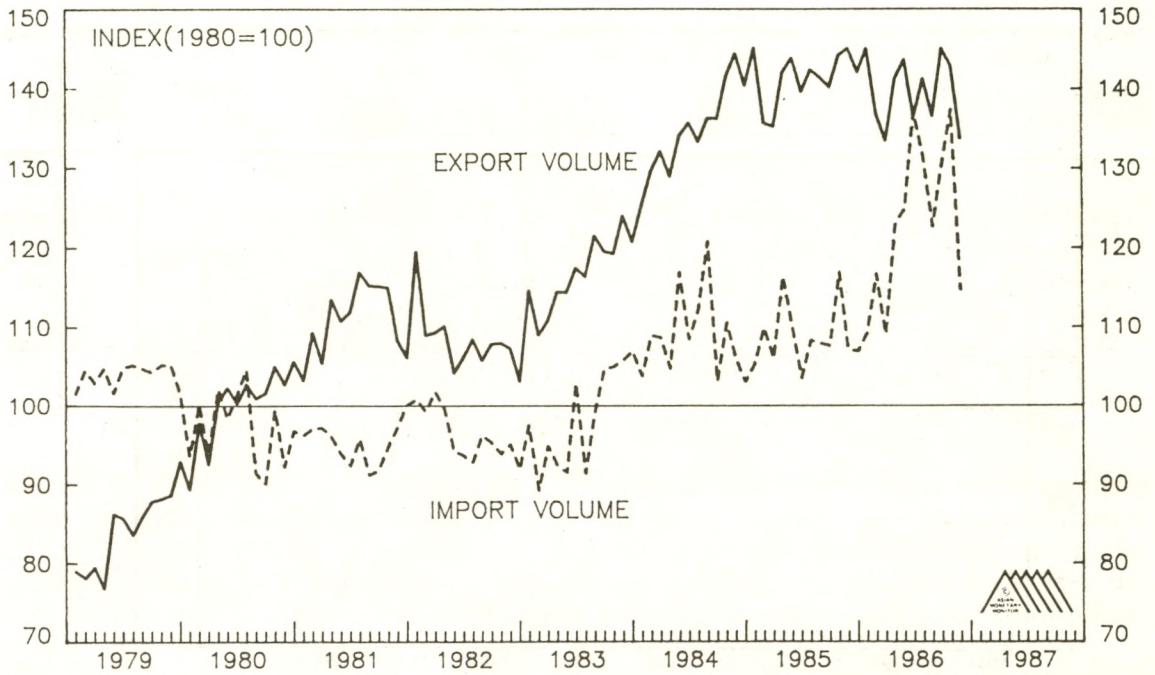


Japan's trade surplus widened substantially in 1986, rising to US\$82.7 bn for the calendar year, from US\$46.1 bn for 1985. The chart above shows the generation of this surplus from exports minus imports in dollar terms. From the chart it can be seen that the increased surplus was the result of a sharp rise in dollar exports, while imports remained essentially flat throughout the year.

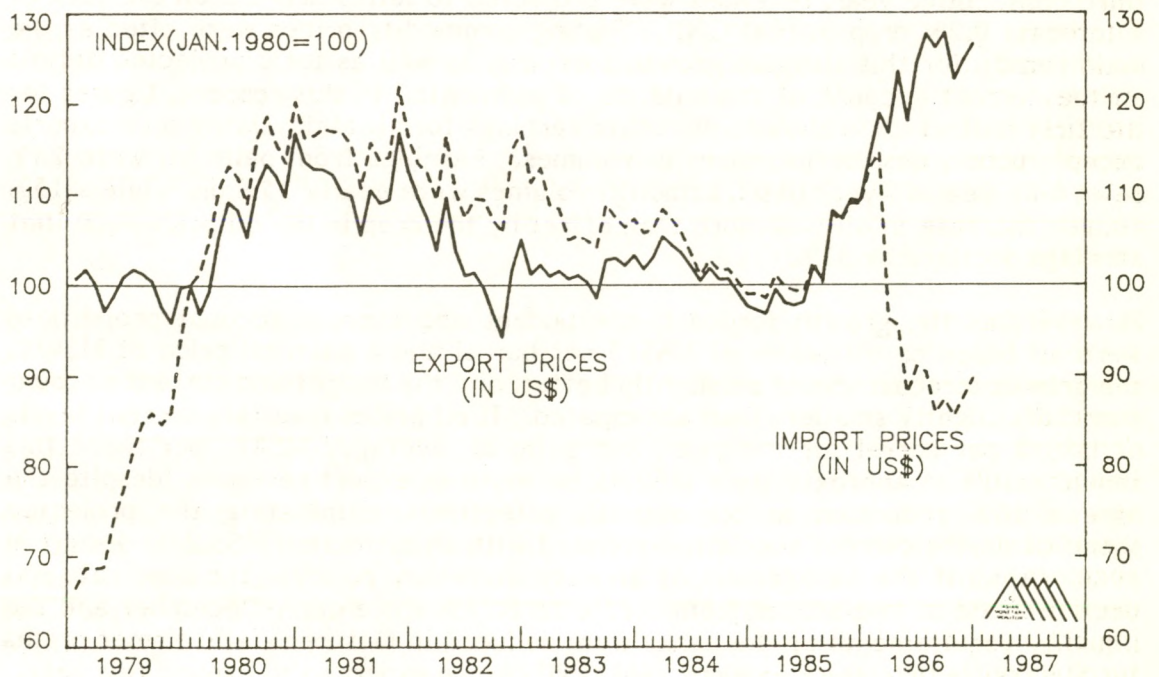
The two charts opposite shed more light on the trade imbalance. From the charts it can be seen that the growth in the trade surplus in 1986 was entirely the result of price movements, as export and import volumes moved adversely for Japan throughout the year. Import volumes rose, albeit erratically, but the effect on import values was more than offset by a collapse in dollar import prices. The sharp fall in import prices was entirely related to the fall in the prices of oil and mineral fuels, as the average cost of Japan's imported crude petroleum fell from US\$27.57/bbl in February to US\$10.34/bbl by August. Similarly, export volumes, which peaked in late 1984, displayed a slight downtrend throughout the year but export prices, and consequently export values, continued to rise sharply. The rise in export prices resulted from the strengthening yen, which meant that exports invoiced in yen (about 40% of Japan's total exports) returned greater dollar revenues and the prices of exports priced in dollars (e.g. autos) were often raised as Japanese exporters attempted to protect margins. These 'terms of trade' effects, therefore, explained more than the whole of the improvement in Japan's trade surplus in 1986.

In 1987 Japan's trade surplus is likely to deteriorate markedly, as the terms of trade improvement is already largely over. It is unlikely that Japan's cost of imported oil for the year will be below the average for 1986 (US\$16.42/bbl) and therefore, if import volume maintains its recent trend (which it should, as domestic spending improves), total imports could grow by up to 10%. More importantly, on the export side, the largest part of the rise in export prices is now likely to have taken place. Furthermore, if the yen does strengthen significantly further, the export volume decline would almost certainly accelerate. If the yen remains stable, current volume trends would suggest a decline in total exports of 10%, or possibly more. Putting these export and import numbers together suggests that we should expect to see Japan's trade surplus contract to the US\$40 bn - US\$50 bn range in 1987.

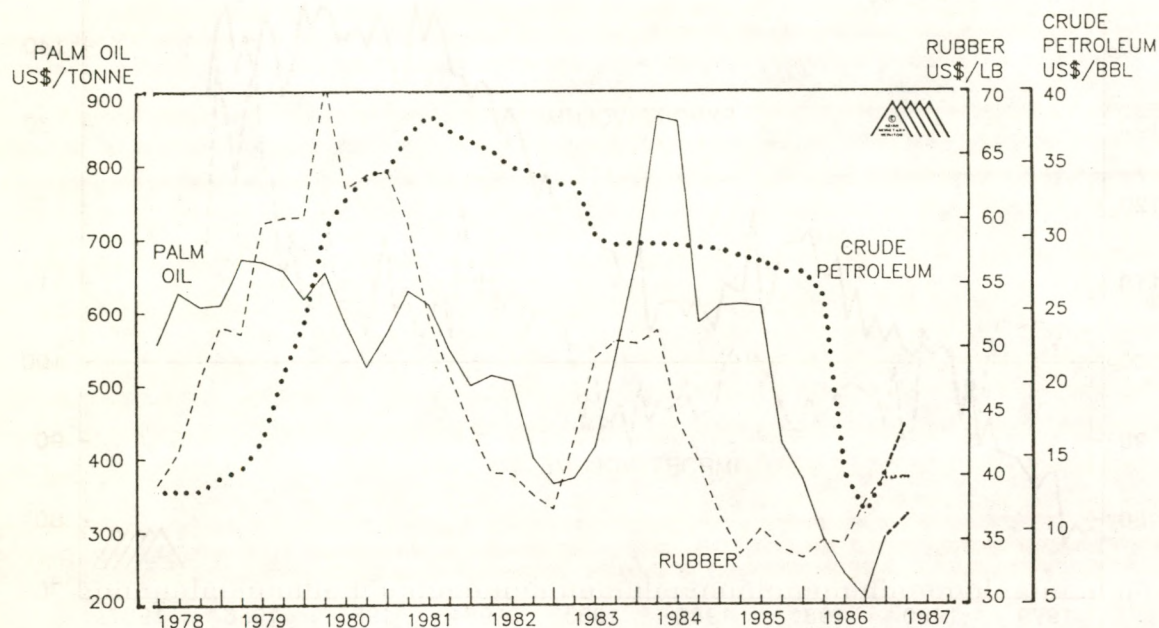
JAPAN EXPORT AND IMPORT VOLUME



JAPAN EXPORT AND IMPORT PRICES



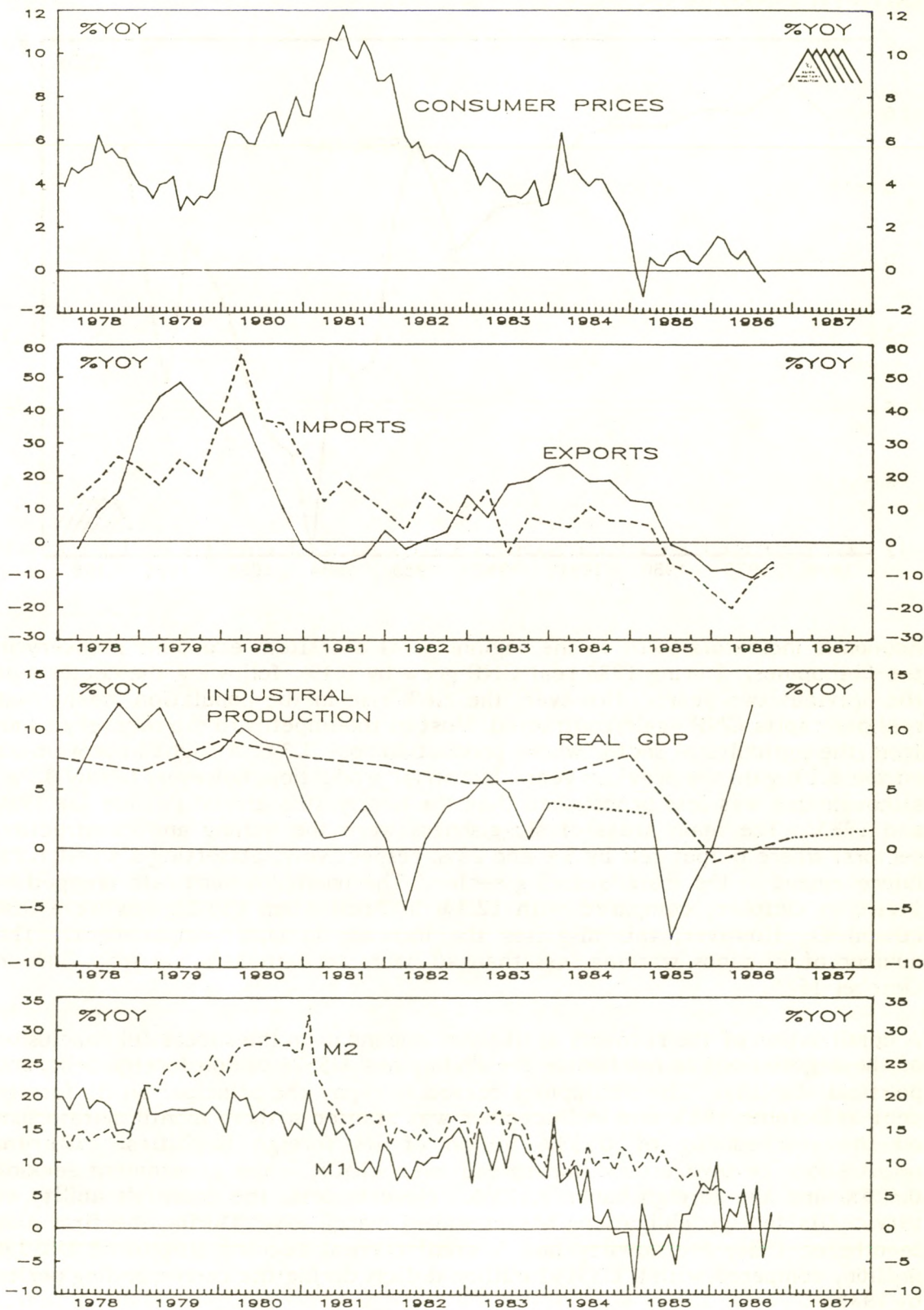
MALAYSIA: FIRMER CRUDE OIL AND PALM OIL PRICES IMPROVE GROWTH PROSPECTS



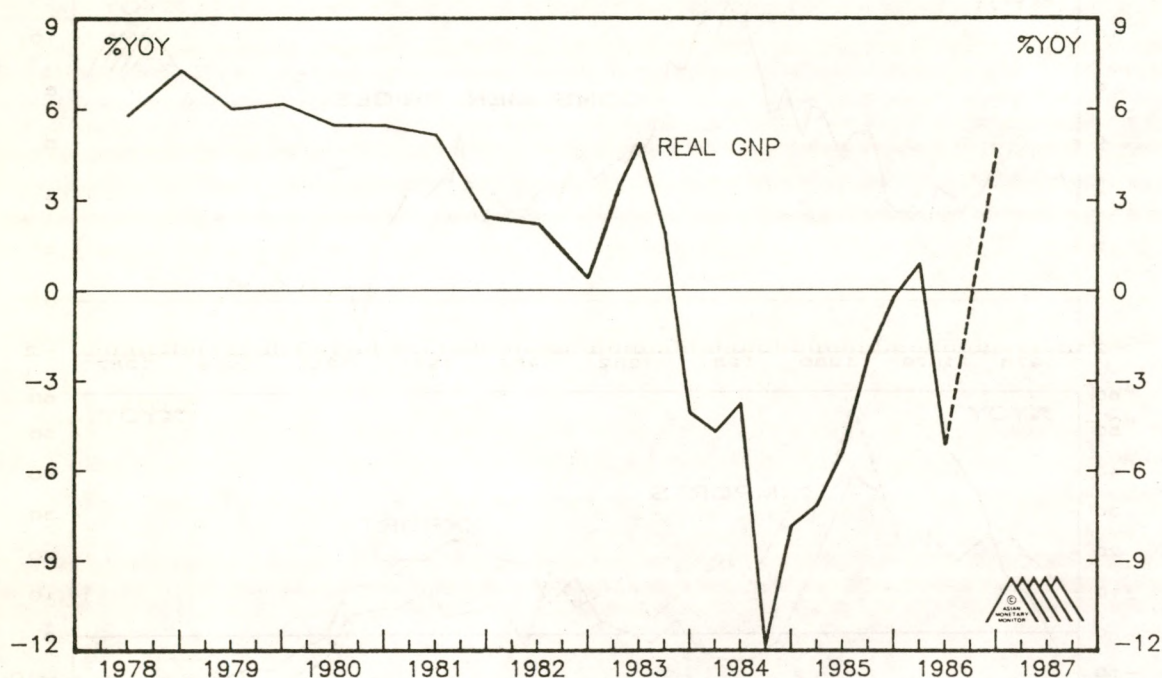
Malaysia's 1987 budget was presented by the Finance Minister Daim Zainuddin on October 24th last year. The main features were the extremely cautious assumptions on which the budget was based and a projected deficit on the operating account for the first time. Despite cutbacks in expenditure for the third consecutive year, revenues were projected to fall nearly 6% on the back of a forecast 0.2% drop in real GNP. Falling commodity prices were cited as the main reason for this sluggish growth forecast, as well as for a projected deficit on the current account of the balance of payments. In this respect, figures for the first half of 1986 showed declining earnings for all Malaysia's major exports except rubber, despite increases in volumes. Earnings from palm oil were 28% down on a year-on-year basis, although volumes were nearly 35% up, while a 15% volume increase in oil was more than offset by the drop in the oil price such that earnings declined by 31%.

However, as the growth forecast, the budget and current account projections were all based on oil prices of US\$13 per barrel and a palm oil price of M\$470, the growth forecast should be slightly better, and the budget and current account shortfalls slightly smaller, than anticipated. If oil prices maintain current levels of US\$18 per barrel for the year, and palm oil averages M\$820 per tonne this should result in approximately M\$2.96 bn more in export revenues (despite the agreed 10% reduction in oil output), effectively eliminating the projected shortfall on the current account, compared with an estimated M\$3.2 bn deficit in 1986. Against the background of an easy monetary policy - the base rate has been reduced in two stages from 9.75% to 8.25% since early December and the liquidity requirements of the banks were reduced in October - and firmer prices for Malaysia's two major exports, real GNP can be expected to expand this year.

MALAYSIA MONEY, OUTPUT, TRADE AND PRICES



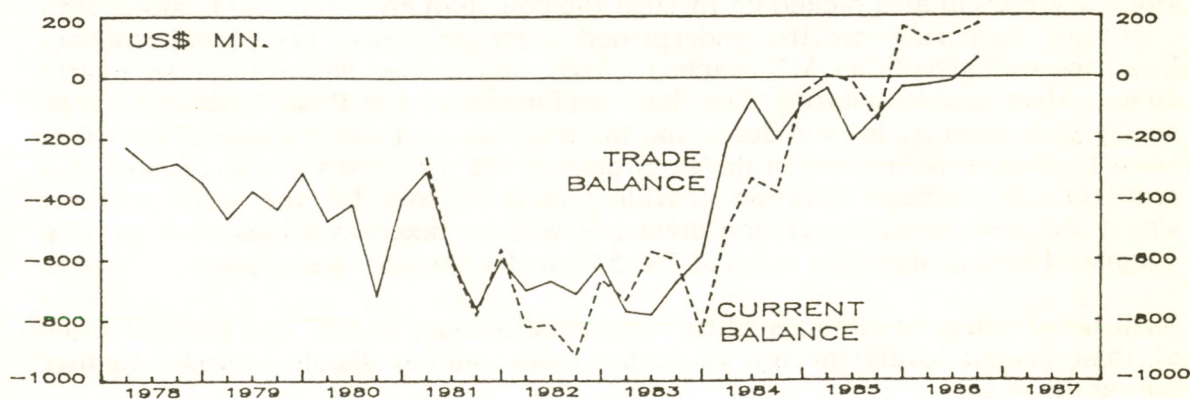
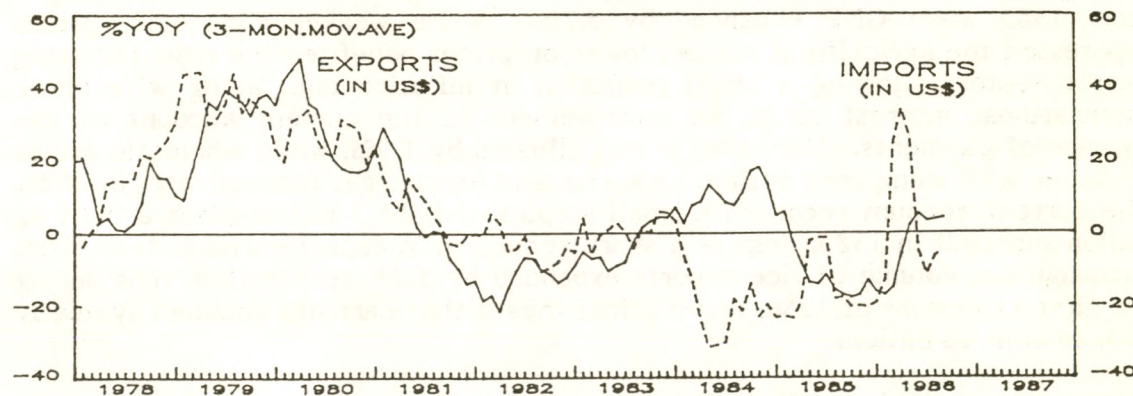
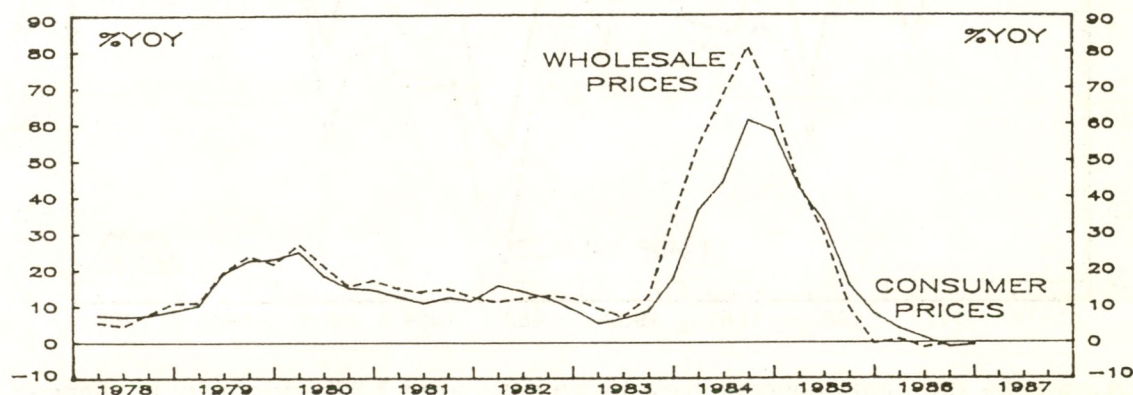
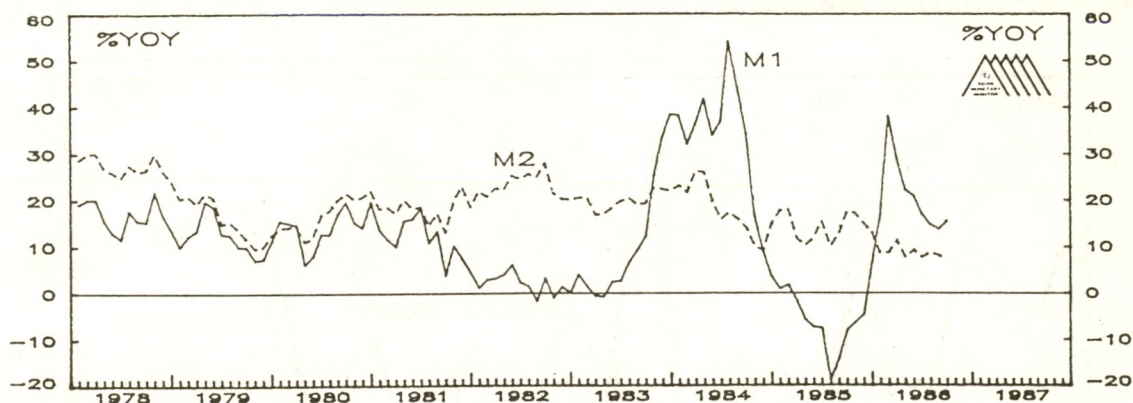
PHILIPPINES: ECONOMY STAGES A HESITANT RECOVERY



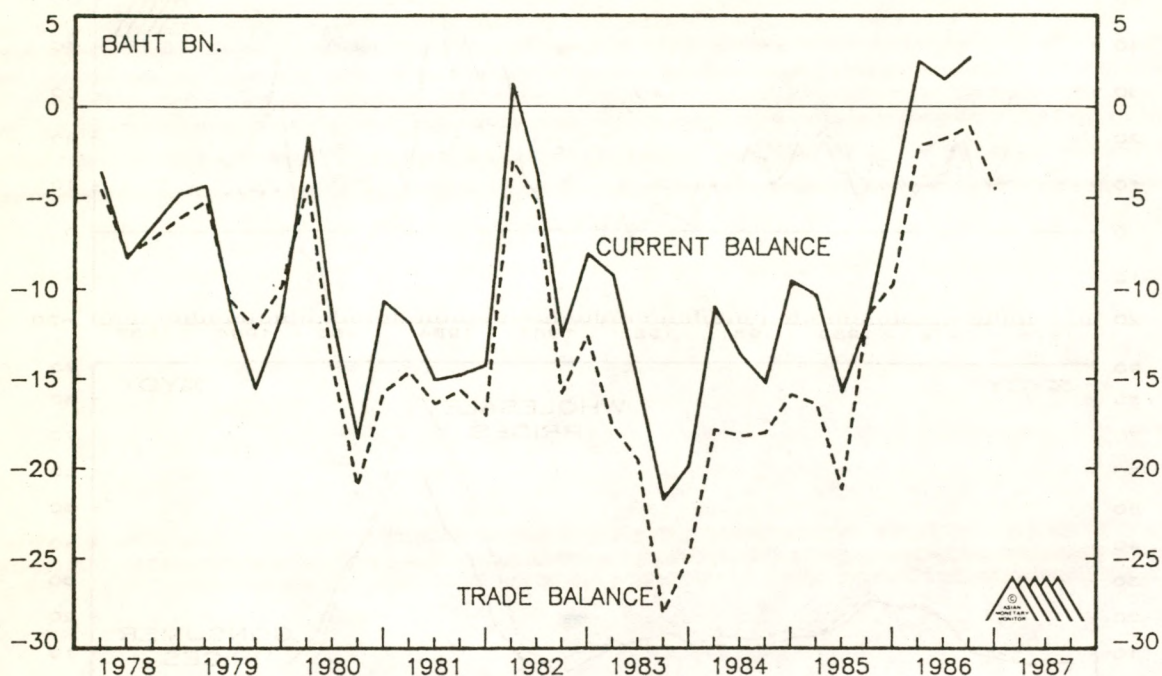
Economic indicators point to the beginnings of a hesitant economic recovery in the Philippines. During 1986 real GNP grew by 0.1%, following the declines of the previous two years. However, the 2.6% rise in the population meant that real per capita GNP again contracted. Most of the impetus to the recovery came from the agricultural sector where production rose 3.3%, a slight improvement on the 3.2% gain the previous year. Industrial production, however, fell by 3.7%, although this was less pronounced than the nearly 10% annual decline for 1984 and 1985. The main areas of sluggishness were the mining and construction sectors, where output fell by 9% and 28%, respectively, offsetting a small 1.2% improvement in the manufacturing sector. The unemployment rate dropped to 11.1% in October, compared with 12.8% in April when the figures were last compiled. However, this disguises the increase in under-employment. The number of Filipinos working less than 40 hours rose to 36%, up from 34% in October 1985.

A continuation of the recovery is likely to depend upon the successful conclusion of the negotiations to reschedule the Philippines' US\$26 billion foreign debt, and political stability. The Philippines ceased to repay the principal on its foreign debt in October 1983, and in December was granted a three month moratorium on the rescheduling of US\$3.6 billion of its foreign liabilities. Current negotiations revolve around the spread over LIBOR - the government seeking 0.625% and the foreign banks 1.125%. Nevertheless, the country's ability to service its foreign obligations has improved marginally. During the first nine months of 1986, the country had a small current account surplus of US\$330 million, compared with a US\$192 million deficit during the corresponding period of 1985.

THE PHILIPPINES MONEY, PRICES AND TRADE



THAILAND: FAVOURABLE ECONOMIC PERFORMANCE UNDERPINS BUOYANT STOCKMARKET

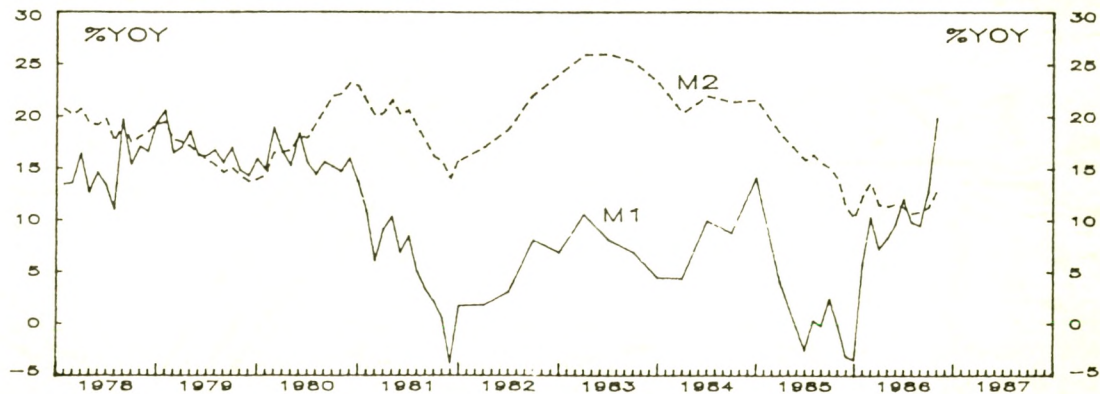
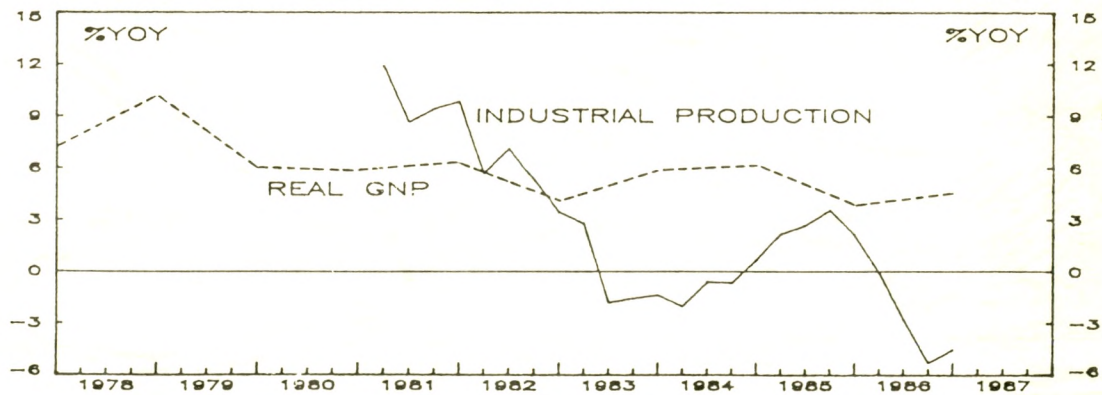
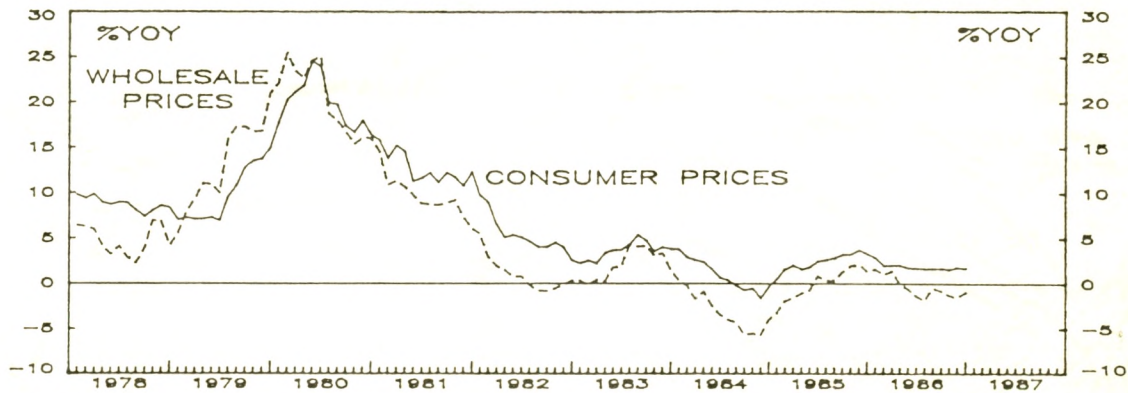
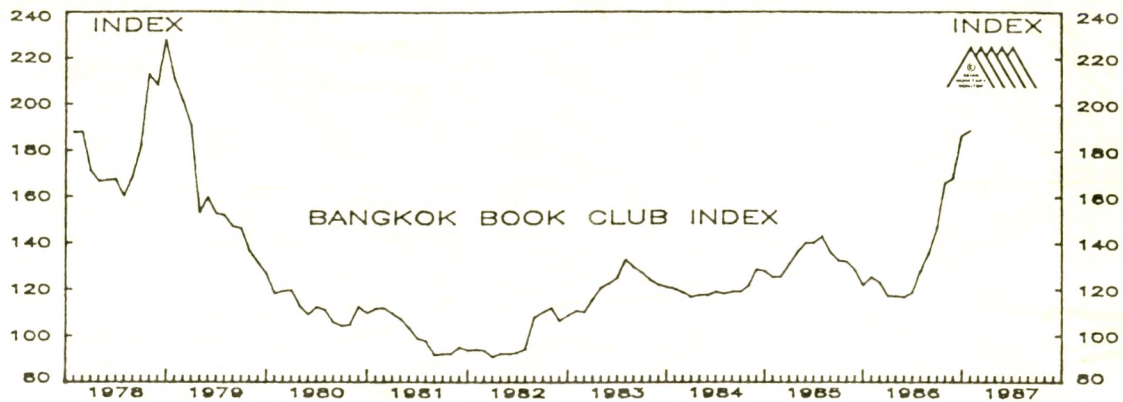


During 1986 the Thai economy grew by an estimated 3.8% - virtually unchanged from 1985 when GNP expanded by 3.7%. While weaker commodity prices suppressed the agricultural sector, lower oil prices benefited the manufacturing export sector, allowing a steep reduction in inflation and, along with lower international interest rates, an improvement in the current account of the balance of payments. Consumer prices climbed by 1.9%, while wholesale prices declined 0.4% compared with a 2.4% rise and no change, respectively, in 1985. The current account recorded a small surplus of Baht 1 billion after a Baht 42 billion shortfall in 1985, despite a sharp reduction in export earnings from rice. Although the volume of rice exports expanded by 5.2% to 4 million tons during the first 11 months of 1986, lower prices meant that earnings declined by nearly 15% to Baht 18 billion.

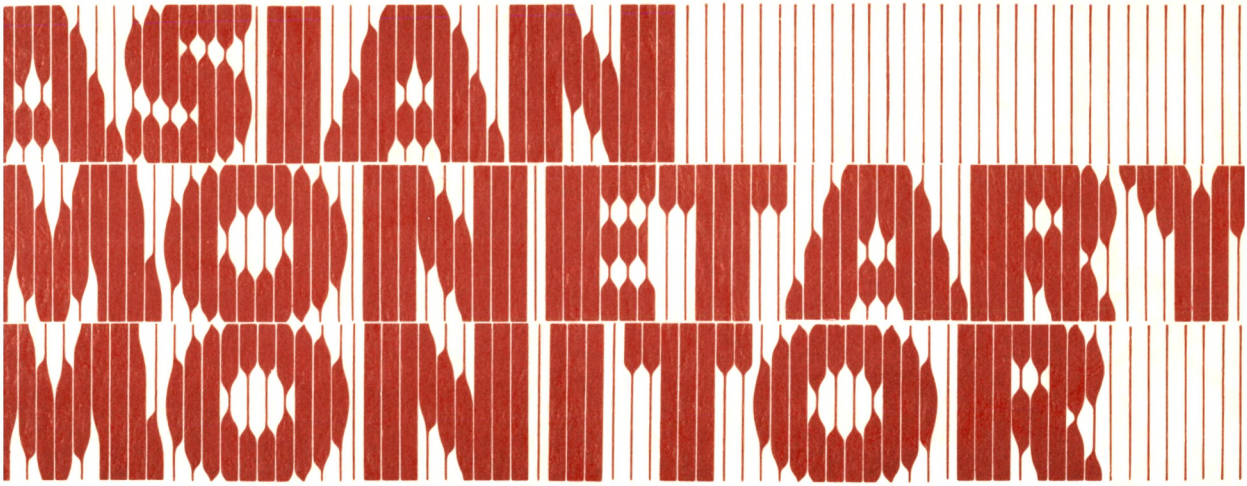
Monetary growth also picked up through the course of the year which, along with improving corporate profits, underpinned a strong equity price performance. Year-on-year growth in M3 reached 13.0% in October while M1 rose nearly 20%. After a disappointing first half performance, the Book Club index rose nearly 63% from its lows in June, and for the year as a whole gained 54%. This momentum was maintained in the early part of 1987, with the announcement of a reduction in dividend taxation providing good support for the stock market. Under the new taxation scheme dividends will be taxed at a maximum of 15% compared with progressive rates of 7%-55% under the previous system.

With fiscal policy becoming slightly more expansionary in 1987 and interest rates at their lowest levels for ten years the stock market should improve further during the year.

THAILAND MONEY, OUTPUT AND PRICES







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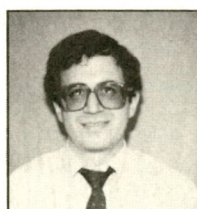
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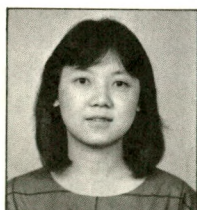
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REPUBLIC OF KOREA: CONTRADICTIONS IN MONETARY POLICY AND IMPLICATIONS FOR THE STOCK MARKET

During the first three months of 1987 the Korean Stock Exchange Composite Index rose by 53%. This brought its cumulative rise since the lower point in September 1985 to 192% (see Chart 1). Because economic growth was rapid and profits responded by climbing by nearly 30% last year the market's rise was achieved without a major erosion of fundamental value. Korean equities remain reasonably priced by international standards. In late March the unweighted price earnings ratio, as calculated by the Korean Stock Exchange, stood at about 11.6 on a historical basis and 9 based on prospective earnings. Although estimates of the weighted historical price-earnings ratio suggest that it could be as high as 18, the market is currently discounting future earnings growth of between 25% and 30%.

Nevertheless, the authorities became concerned that the market had become overheated. On the 2nd April they therefore announced a number of measures to cool the market. In a bid to increase the supply of scrip the Korea Development Bank and the Korean Stock Exchange were directed to sell their shares in several companies, while enterprises with loans exceeding Won 50 billion will be required to replace 10% of their debt with convertible bonds which will not be considered part of the capital base. In combination with new issues which had already been planned for the year these measures are expected to add about US\$2 billion to the current market capitalisation of US\$18 billion. Investment Trusts will in future only be able to hold stock up to a value of 50% of their capital, as compared to 90% previously, while securities companies' maximum holdings of equities are to be reduced from 60% to 40% of their capital base. Reinforcing these steps was the hint that the further opening of Korea's equity market to foreigners, which was due later this year, would be delayed.

These measures caused a sharp correction in the market. By late April the index had fallen by 14% from its highs. But as with previous government interventions in the market, which resulted in only temporary setbacks, the authorities have succeeded in addressing only a symptom rather than the cause of the market's rise. While the rapid increase in corporate profits has been an important factor underpinning the market, the tax treatment of personal property holdings, which makes it unfavourable for an individual to hold more than one property, and rapid growth in the money supply, in the wake of Korea's burgeoning current account surplus, have both resulted in increased speculative activity in the market.

During the first quarter of 1987 the current account surplus amounted to

US\$2.1 billion compared to a US\$313 million deficit in the corresponding period last year and a US\$4.6 billion surplus for 1986 as a whole. Despite an anticipated 7% further appreciation of the Korean won this year, after the 3% gain last year, and a marginal liberalisation of Korea's tight import tariffs and prohibitions, this year's surplus is likely to be in excess of US\$6 billion. The authorities have therefore stepped up their issue of sterilisation bonds, encouraged the early repayment of foreign debt and placed tight restrictions on the acquisition of new foreign loans. The 1987 budget made provision for a total issue of monetary stabilisation bonds and foreign exchange equalisation bonds totalling Won 4.9 trillion (US\$6 billion) - nearly double the amount issued last year. As a result money supply growth (M2), which expanded by 20% year-on-year in January, slowed to 19.2% in February and further to 17.9%, just within the 15%-18% target range, in March. Inflation also continued to remain low, with consumer prices rising by just 1.2% in the year to March.

These successes are, however, likely to prove temporary. Korean monetary policy is currently being conducted in a way that will make it difficult for effective control over the aggregates to be achieved. There is a fundamental contradiction between the authorities' desire to reduce foreign debt, contain the size of the current account surplus and sterilise liquidity resulting from the surplus on the external accounts on the one hand, and the policy of propping up ailing industries on the other. Secondly, Korea's highly regulated banking system, which has effectively concentrated on the mobilisation of funds rather than their efficient distribution, has spawned an active unofficial money (kerb) market. Shifts of funds in and out of the market have made it difficult to gauge the underlying trend in the money aggregates. Thirdly and more importantly, the Korean authorities are trying to achieve control over the money aggregates in a way which in itself is inflationary in the long run, because it contributes to diverting resources from efficient to inefficient industries, intensifying the distortions that already exist within the Korean economy.

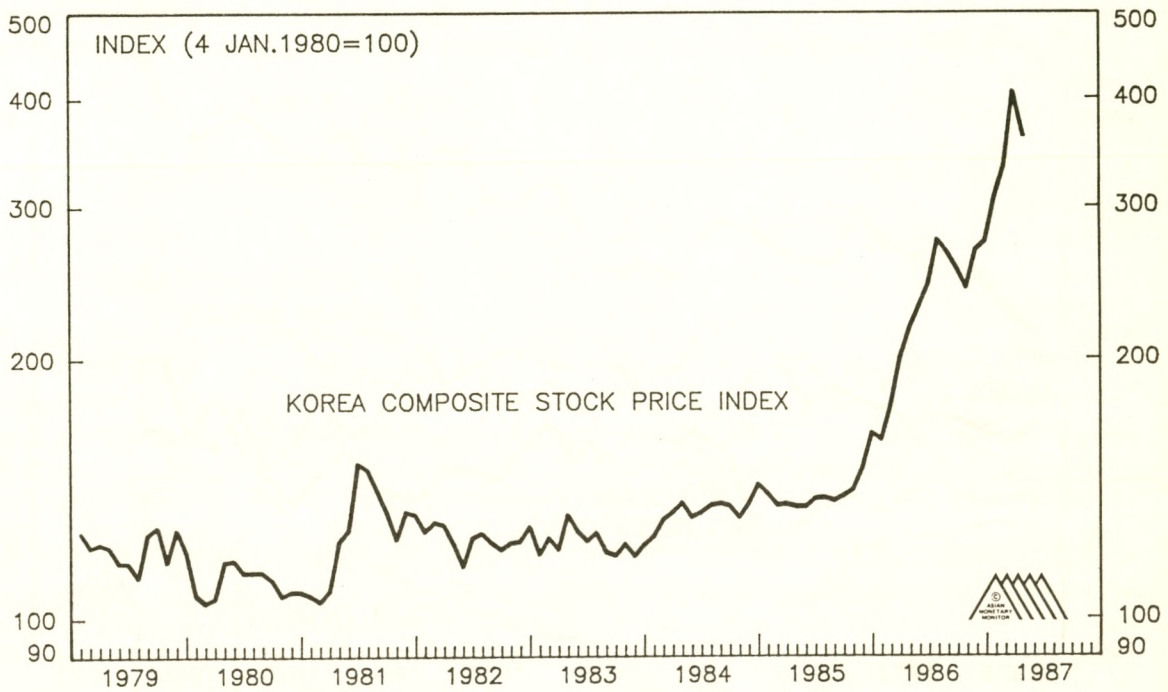
The paragraphs below examine these issues by reviewing recent monetary policy developments and their interaction with the institutional regulations, in attempting to assess the likely implications for the stock market in the short and long run.

Monetary base control

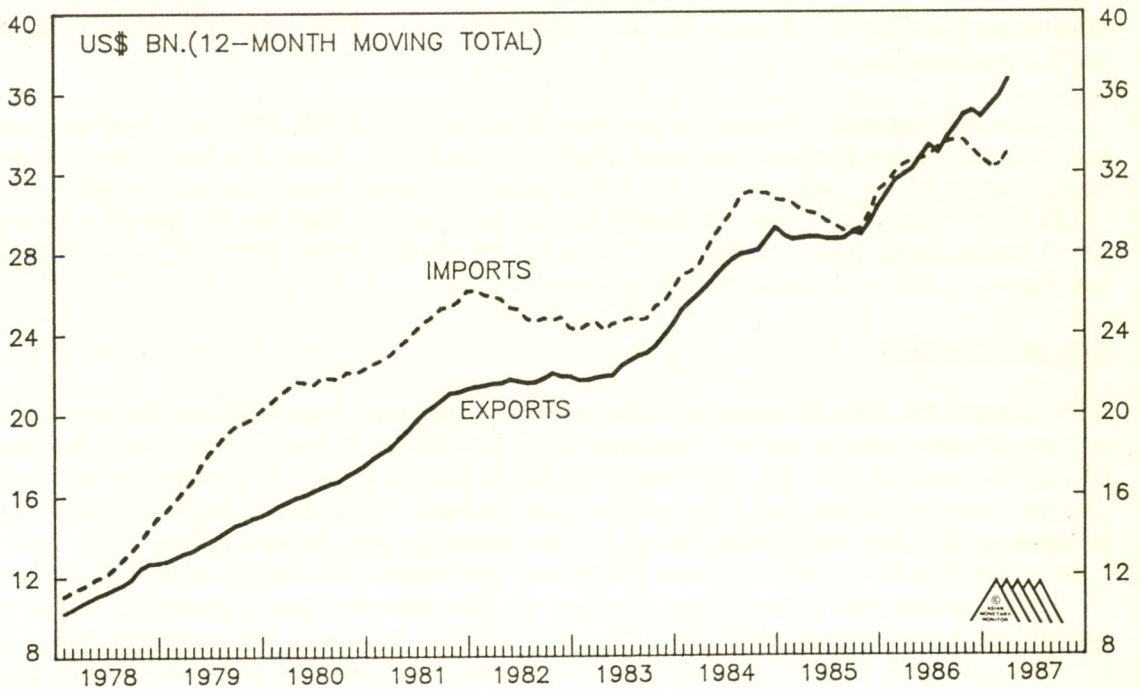
Theoretically the Bank of Korea would be well placed to exercise close control over the money supply were it not for the distortions introduced by their heavy regulation of the banking system. Because the Deposit Money Banks are required to hold reserves which are non-interest bearing, save in exceptional circumstances such as last year when they were paid 2% to help them over their difficulties, the Bank of Korea should be able to operate efficiently on the monetary base. Although the deposits to cash ratio has tended to rise over time, as real income gains have caused individuals to hold a higher proportion of their precautionary and transactions money balances in financial institutions, the impact on the money multiplier has been steady and predictable.

Chart 3 shows the recent movements in the monetary base and its components up to December last year. The movements in the net foreign asset component of the base highlight the authorities' concern about the inflationary

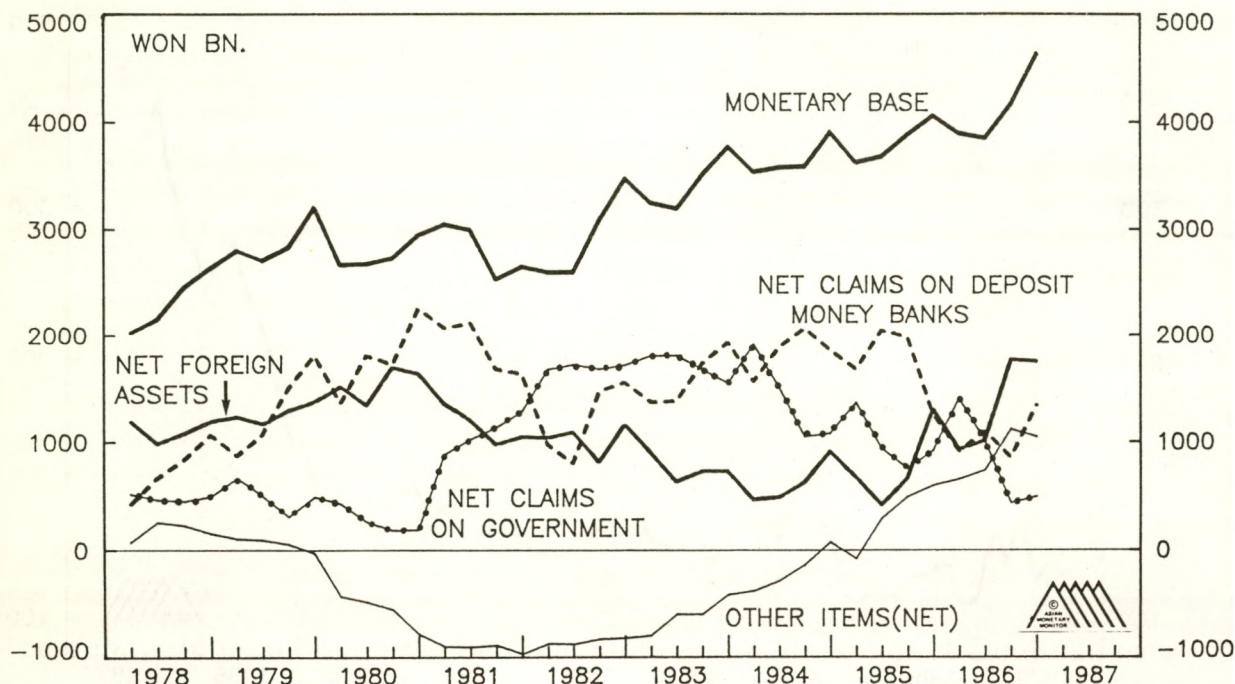
S.KOREA: CHART 1 THE KOREAN STOCKMARKET



S.KOREA: CHART 2 EXTERNAL ACCOUNT



S.KOREA: CHART 3 COMPONENTS OF MONETARY BASE



impact of the current account surplus. Between the end of 1981 and mid 1985 the net foreign asset component fell steadily as continuous current account shortfalls were only partially offset by capital inflows. The contractionary impact on the monetary base, and hence domestic banks' ability to create credit, was offset by central bank accommodation. This is shown by the increase in net claims on the Deposit Money Banks and, until mid-1983, by the rise in net claims on the government.

As the current account swung into surplus in mid-1985 the net foreign asset component began to exert an expansionary influence. Because the economy was more liquid the gross claims on the Deposit Money Banks began to grow at a slower pace and the Bank of Korea began to sterilise the rise in the net foreign asset component by accelerating the issue of stabilisation bonds. Net claims on the Deposit Money Banks therefore began to fall.

The kerb market

However, the impact of the Bank of Korea's sterilisation activities on overall money supply growth was not as effective as it might have been because of re-intermediation. The last issue of AMM (Vol. 11 No. 1) highlighted the close controls exercised on the Korean banking system. Interest rates are effectively regulated by the authorities and credit ceilings are in operation. An active unofficial (kerb) money market therefore operates. Although there is no hard evidence about the size of the market or the interest rates charged, available anecdotal evidence suggests that the differential between kerb market rates and official market rates began to narrow sharply last year as the economy became

more liquid. There was therefore a shift out of the kerb market into the official banking system - a tendency which was accelerated by default on kerb market obligations by construction companies which had run into difficulties. In one sense this should provide comfort to the authorities because it means that a certain portion of recent money growth is non-inflationary. But, it also highlights the difficulties of attempting to achieve money supply targeting by operating on the monetary base in an environment of direct credit controls.

Industry support

What is also interesting is the rise in net claims on the Deposit Money Banks in the final quarter of last year owing both to a net redemption of monetary stabilisation bonds and an increase in the gross claims on the Deposit Money Banks. While the heavy issuance of monetary stabilisation bonds due for the first half of this year almost certainly means that the net claims on the Deposit Money Banks will decline this year, tentative signs suggest that this will not be by as much as originally estimated.

Within its constitution the Bank of Korea has the power to extend special policy loans to ailing industries. Between late 1985 and December last year these were issued sparingly, because, as loans from the Bank of Korea, they add directly to the monetary base. The refusal of the Bank of Korea to extend a direct policy loan to the ailing shipbuilding industry early this year seemed to suggest that this policy had survived intact into 1987. But, in the case of the announcement of the extension of a Won 1.3 trillion loan to the farming sector, which forms a large part of the ruling DJP power base, politics seems to have prevailed.

Induced inefficiencies

Even if this loan was sterilised, which would require raising this year's budgeted issue of stabilisation bonds, the long-run impact of this loan is still likely to be inflationary as it courts inefficiency by transferring funds away from the efficient sectors of the economy. This tendency is further exemplified by the authorities' desire, for political reasons, to reduce Korea's gross foreign indebtedness. The ostensible economic reasons for reducing foreign debt are twofold: it restrains money supply growth and reduces reliance on high cost foreign loans. To this end early repayment of 'bad' foreign loans, defined as anything in excess of 0.7% over LIBOR, has been encouraged, while access to new foreign loans has been severely limited. However, it is debatable as to whether the early repayment of foreign debt by the private sector does actually exert a contractionary influence on the money supply because the policy loan to the farmers, unless sterilised, provides the banking system with the reserves to replace these foreign loans with domestic loans. But in any case the argument over the cost of finance is clearly incorrect. If current estimates of an expected 7% appreciation of the Korean Won this year prove correct, then the effective interest rate cost of offshore borrowing in the Euro-dollar market at current rates would at worst be zero. Borrowing domestically at prime would, from Korea's highly regulated banking system, involve a cost of around 11.5%.

These inefficiencies induced by the current conduct of monetary policy are reinforced by the regulations governing the distribution of bank assets. Up to

now the emphasis has been on the effective mobilisation of funds to reduce reliance on foreign capital in the face of a capital deepening in the economy. In this the authorities have met with some success. By last year the domestic savings ratio had climbed to nearly 33% - higher than in Japan. These funds have been directed to priority areas according to directives governing the proportion of bank assets which must be lent to small and medium sized companies (see AMM Vol. 11 No. 1). This is supported by a system of preferential financing rates. The current rate on commercial bank overdrafts varies between 11% and 12.5%, while the rate on loans to shipbuilding, agriculture and fisheries is 10% to 11%. Depending on the size of borrowers the rates vary from 10% to 11.5% for medium industries, and 5%-10% for loans made with small and medium industry promotion funds. Rates also vary widely among the co-operatives and the various specialist banks.

Stock market implications

The inefficiencies resulting from the conduct of monetary policy are likely to have a substantial impact on the stock market in the medium-term. One of two things is likely to occur. Either the Korean authorities will continue with a policy of a closed and regulated economy, inviting protectionist pressures, or they will accelerate the pace at which the economy is liberalised by deregulating interest rates, opening the market to imports and boosting internal demand, thereby creating more balanced economic growth.

Even in the protectionist scenario, the pressures will be on the Korean authorities to desist from intervening in the distribution and price of credit and instead allow the market to distribute funds more efficiently. In this scenario, the stock market will remain subdued. The authorities will initially continue to appreciate the Won to counter protectionism, reducing export margins. Export volume growth will also begin to slow, unless the Japanese yen continues to fall, as overseas markets become increasingly difficult to penetrate. If the authorities continue to sterilise the current account surplus without freeing interest rates, the distribution of domestic savings will be distorted in favour of inefficient areas of the economy. Eventually under this scenario the current account surplus will be eroded as exports stagnate, at the expense of increased inefficiencies in the economy and a corresponding drop in the long-run growth potential. At this point economic circumstances may impel a liberalisation of the economy, at a time when Korean corporations' ability to compete with imports has been severely eroded.

The implications for the stockmarket of the more immediate liberalisation scenario, which would include a relaxation of the restrictions on foreign participation in Korea's equity markets, are positive. With protectionist measures averted, export stocks should perform well. Efficient distribution of credit and an exchange rate which responds to market forces will enable continued strong growth in exports. The market should deepen as domestic demand expands, with a corresponding drop in unit costs as economies of scale are reaped from higher production. Demand for scrip would expand as foreigners become involved in the equity markets. The resulting rise in the stock market would also make it increasingly attractive for Korean corporations to expand their capital base via recourse to the equity markets rather than bank loans. The ability of the Korean authorities to control money supply growth would

therefore also be enhanced.

FORECAST

But, whichever medium-term scenario emerges, the inbuilt inefficiencies in the financial system will ensure that the authorities will have difficulty containing money growth this year unless there is a sharp slowdown in export growth. The stock market is therefore likely to begin to rise strongly again within the next few months, barring a major deterioration in the political environment. Despite the economic inefficiencies reinforced by the current conduct of monetary policy, profits growth will continue to remain buoyant. While the projected rise in the Korean Won will require that Korean corporations make increasingly efficient use of existing resources, they will nevertheless continue to gain export market share at the expense of the Japanese owing to the sharper rise of the yen against the US dollar.

TAIWAN: APPROACHING THE LIMITS TO EXPORT-LED GROWTH

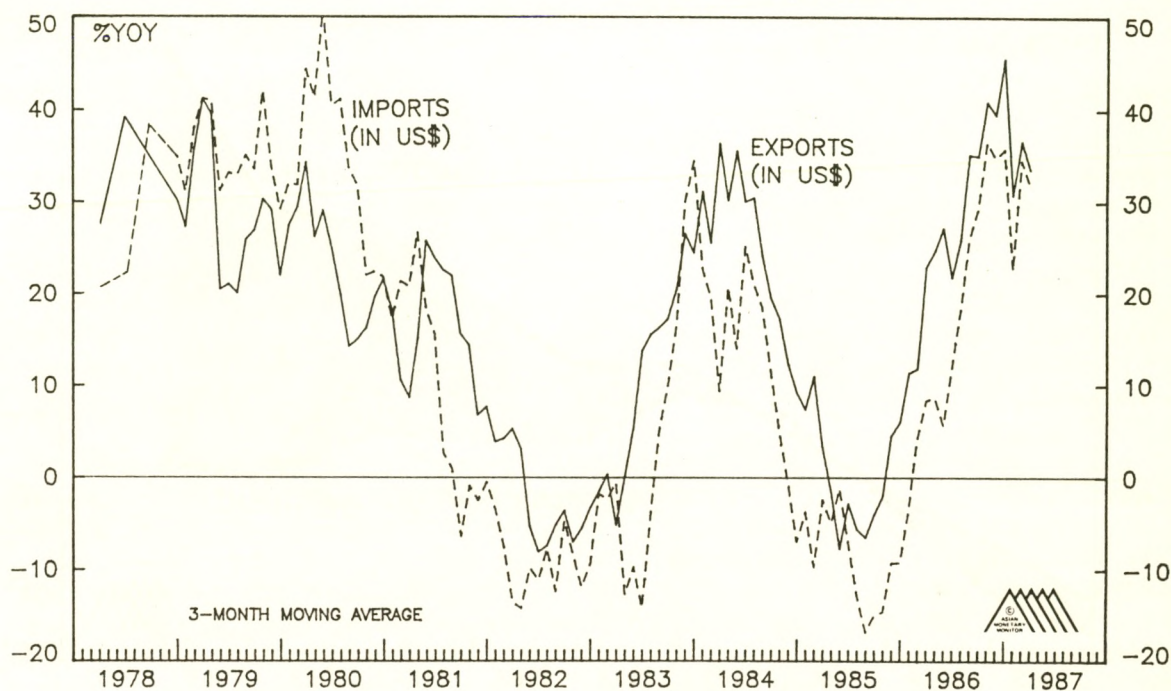
Over the past year Taiwan's surging exports and massive current account surplus have brought the island of nineteen million people into the spotlight of world attention. Taiwan's foreign exchange reserves surpassed US\$50 bn in February, more than double the level of a year earlier, placing the republic in the company of Japan and Germany as the world's largest holders of foreign exchange reserves. More importantly, Taiwan's burgeoning bilateral trade surplus with the United States - which reached US\$13.6 bn in 1986 - led to the republic's import and exchange rate policy being singled out by US legislators as one of the reasons why the overall US trade deficit has not responded more favourably to the sharply weaker US dollar.

At least superficially, Taiwan itself appears to have enjoyed enormous benefits from its exceptional export performance. Export growth reached 44.6% year-on-year in the fourth quarter of 1986 (see Chart 1), allowing GNP to grow by 10.8% in real terms for the year as a whole. At current exchange rates, Taiwan's per capita GNP now stands at US\$4,300, only bettered in Asia (outside the Middle East) by Japan and the city-states of Hong Kong and Singapore. Nevertheless, there is another side to Taiwan's trade performance, namely the chronically weak domestic economy which it has mirrored. This is a theme which has been discussed in previous issues of AMM (see particularly AMM Vol. 9 No. 4, July-August 1985), but bears further examination at this time, particularly as it is becoming increasingly obvious that Taiwan will not for much longer be able to experience economic growth of such a lop-sided nature.

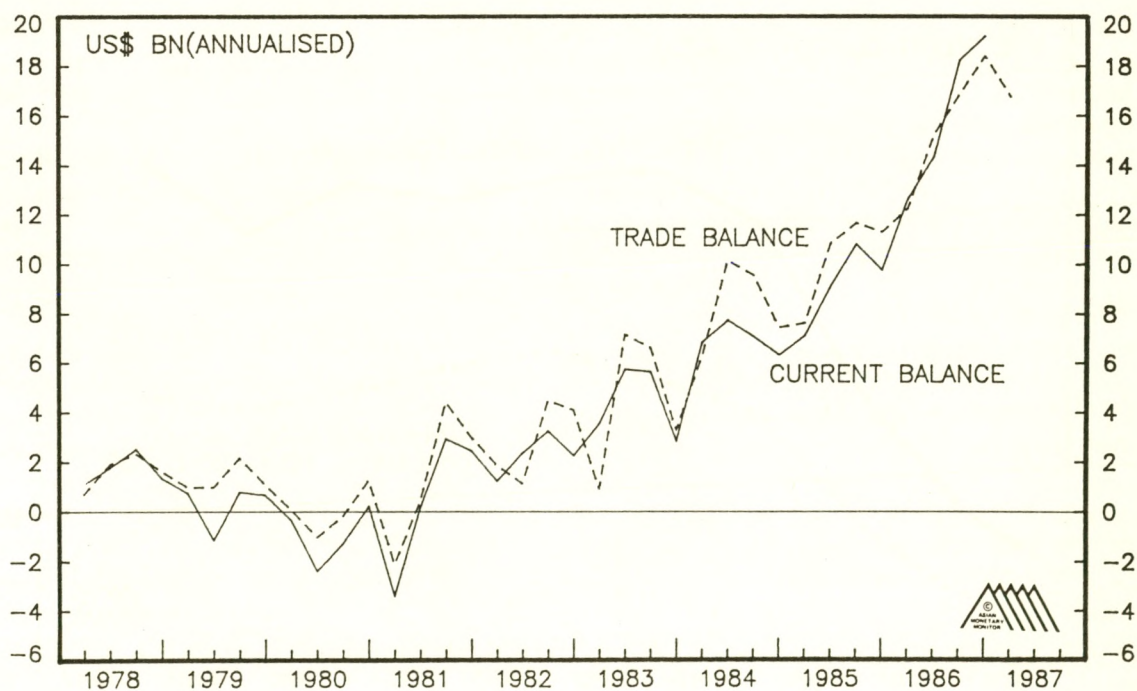
In a national accounting framework a country's current account surplus is the counterpart of a positive gap between savings and investment i.e. it represents the difference between gross national savings and gross capital formation. This is simply because in aggregate all savings must, by definition, be invested and national savings which are not invested domestically (representing gross capital formation) must be invested overseas, representing an increase in net foreign assets corresponding to a current account surplus on the balance of payments. In one sense, therefore, given that a country running a persistent current account surplus must, by definition, be saving, and investing part of those savings overseas rather than domestically, it is tautologically true that its 'domestic economy' will be growing at a slower rate than the 'potential' represented by its national savings. However, this does not necessarily mean that its domestic economy will be weak. To ascertain this, we need to examine the sources of the savings/investment gap, and the components of investment and growth. This is done for Taiwan in Charts 3 to 6.

Chart 3 illustrates Taiwan's current account surplus in New Taiwan dollar terms (represented by the shaded area on the chart) as generated by the excess of gross savings over gross investment, in nominal terms. From the chart it can be seen that over the past ten years Taiwan's nominal gross savings have exhibited a fairly constant uptrend, but that since 1981 a widening savings/investment gap (i.e. current account surplus) has emerged as gross

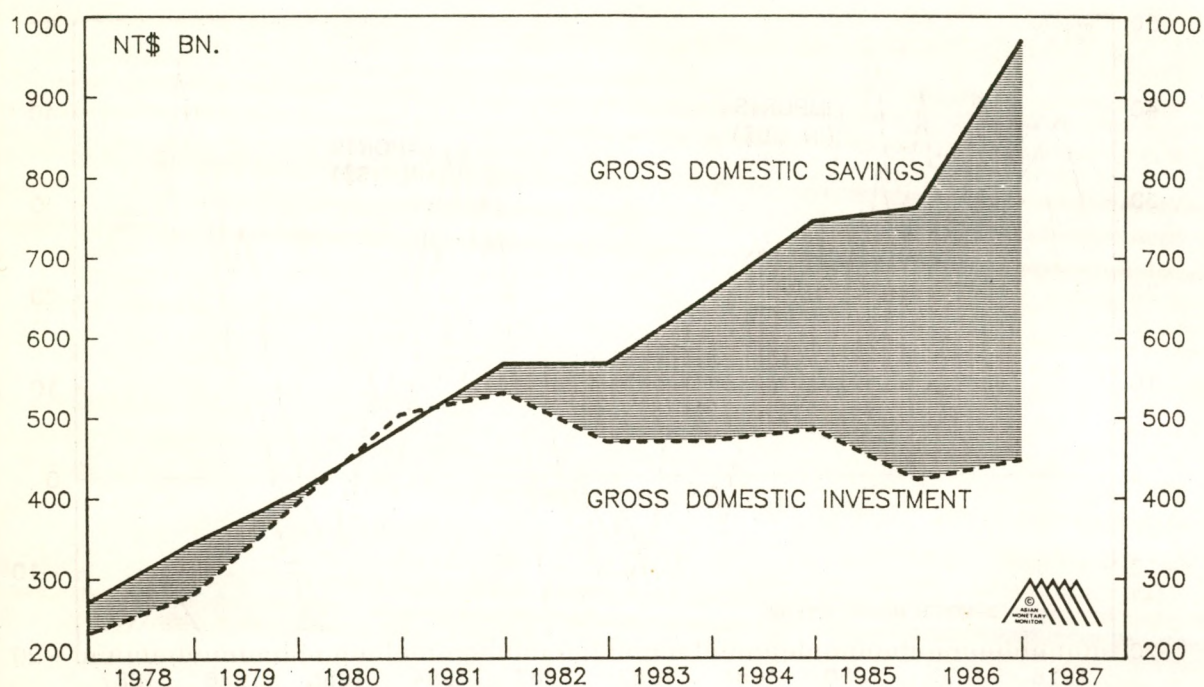
TAIWAN: CHART 1
EXPORTS AND IMPORTS GROWTH



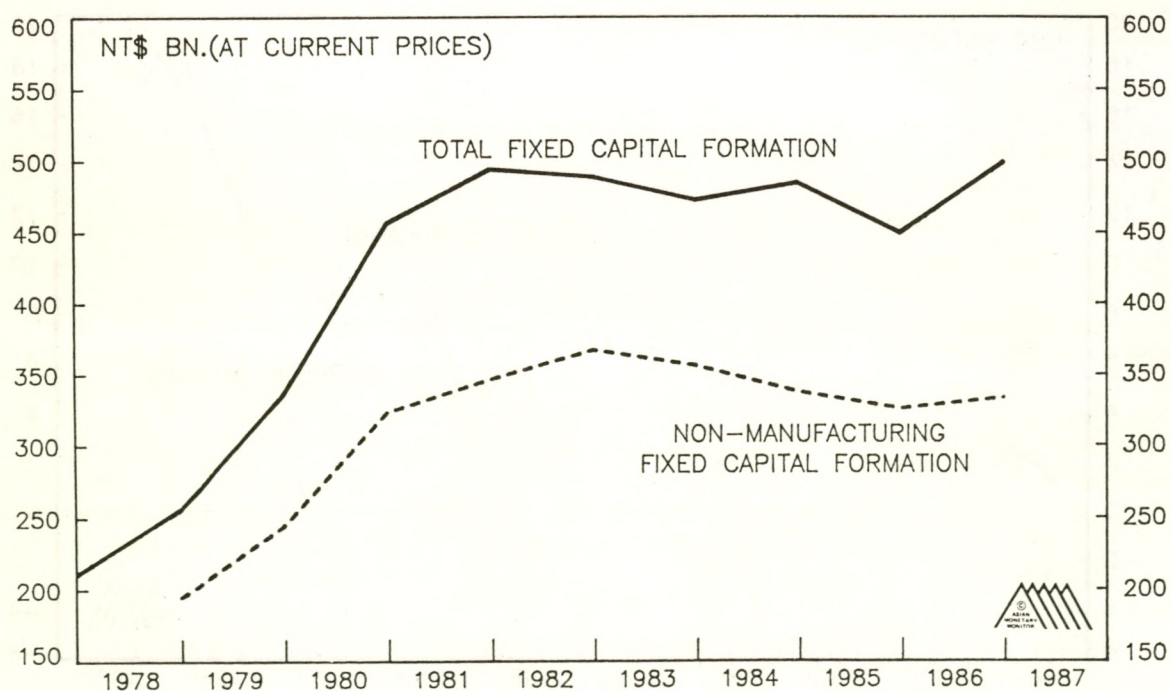
TAIWAN: CHART 2
THE CURRENT ACCOUNT SURPLUS



TAIWAN: CHART 3
GROSS SAVINGS AND INVESTMENT



TAIWAN: CHART 4
FIXED INVESTMENT

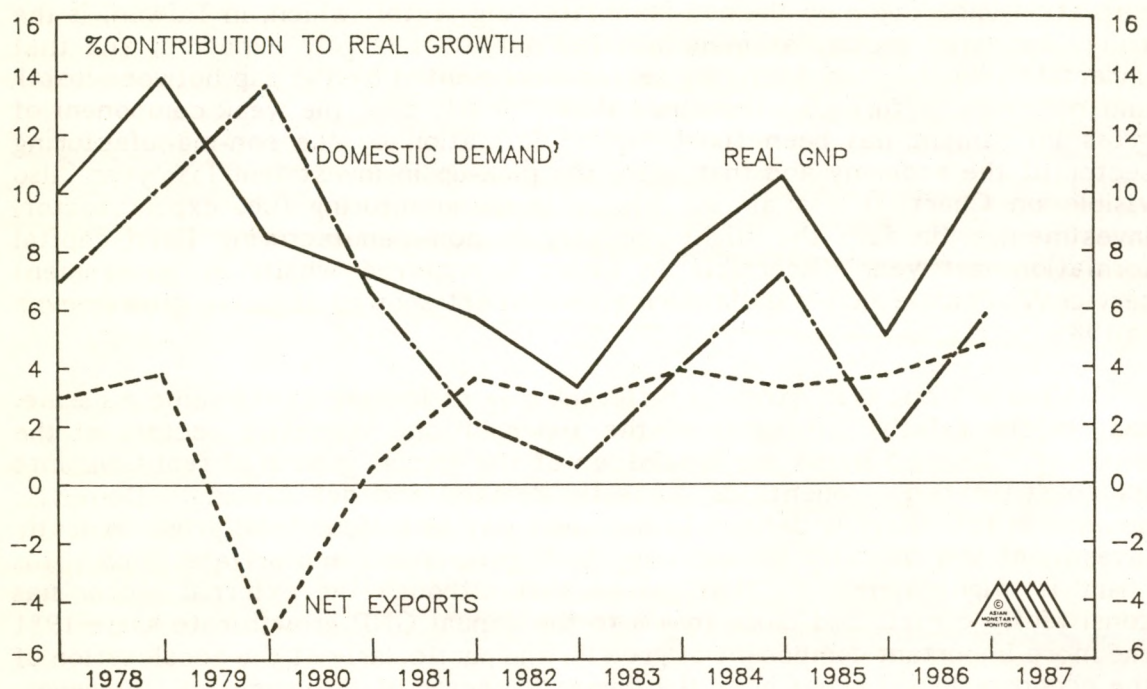


investment has failed to grow, in fact showing negative growth since 1981. Gross domestic investment comprises fixed capital formation and inventory accumulation. In Chart 4, fixed capital formation is separated into fixed capital formation undertaken by the non-manufacturing sector (which, in Taiwan, is the truly 'domestic' sector, as manufactured output is largely exported) and that undertaken by the manufacturing sector (represented by the gap between 'total' and 'non-manufacturing'). The chart shows clearly that the weak component of gross investment has been fixed capital formation by the non-manufacturing sector of the economy and that, also, the pick-up in investment last year (also visible on Chart 3) was almost wholly in manufacturing (i.e. export sector) investment. (In fact the slight recovery in non-manufacturing fixed capital formation last year discernible in Chart 4 occurred wholly in 'government services'. Private non-manufacturing investment showed negative growth even in 1986.)

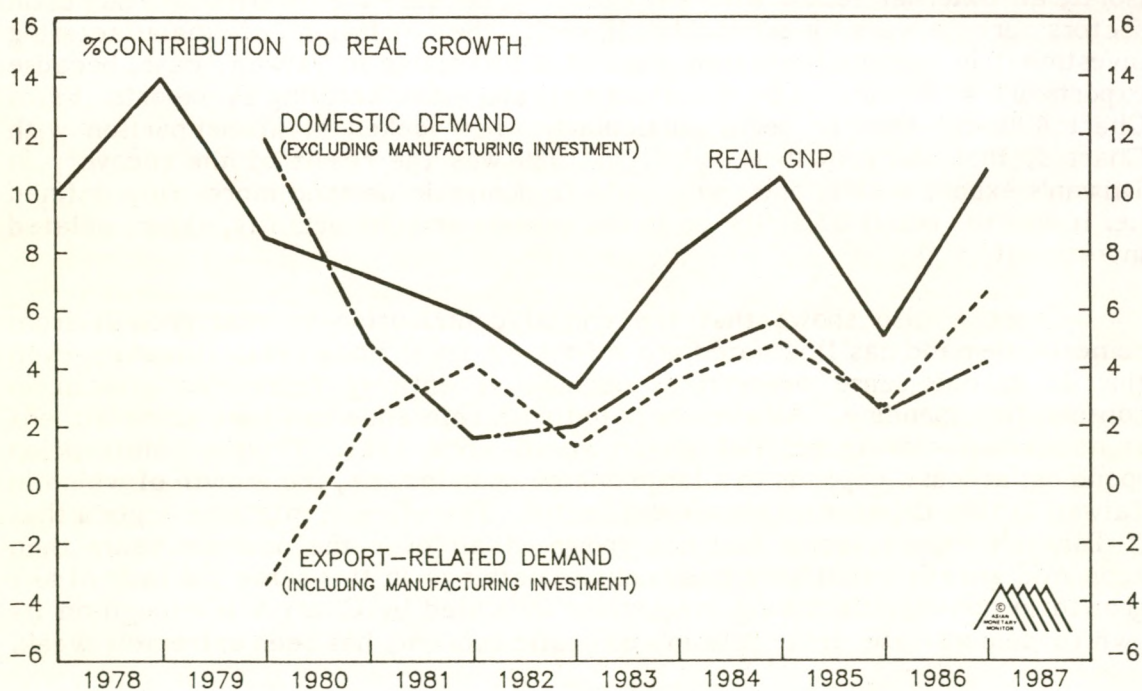
Charts 5 and 6 illustrate a different way of looking at the same issue i.e. that of the relative strengths of the 'external' and 'domestic' sectors of the economy. Chart 5 shows the breakdown of the annual growth of real GNE into its constituent components of domestic demand and net exports. Domestic demand in this chart is defined in the usual way to include total gross domestic investment and consumption spending, both government and private. From this chart it might appear at first glance that although the external sector has consistently contributed close to 4% to the annual GNP growth rate since 1981 the more important component of growth, and particularly of the acceleration of the economy in 1986, has been the domestic sector of the economy. However, this would be an incorrect interpretation, as can be seen from Chart 6. In Chart 6 we attempt to approximate to a truer differentiation between the export and domestic sectors of the economy by including fixed investment in manufacturing as part of the export sector, rather than counting this investment as 'domestic' demand. Although only an approximation (because in practice it is impossible to isolate an 'external' sector from any economy, because the external and domestic sectors are always inextricably linked), the inclusion of manufacturing investment in externally-related demand is justifiable in Taiwan's case, because exports are so dominated by manufactures, and manufacturing by exports. From Chart 6 it can then be seen, particularly when looked at in comparison with Chart 5, that the growth recovery in 1986 was the result of the recovery in Taiwan's export sector, and owed little to domestic demand more truly defined i.e. it was the result of a pick-up in net exports and, importantly, export-related investment.

Chart 6 also shows that the annual contribution to real growth from domestic demand has fluctuated around the 4% level since 1981. However, even this is in one sense overstated, because it entirely represents growth in consumption spending. As already noted with reference to Chart 4, investment in non-manufacturing has not grown at all since 1981. Private consumption spending, at least, depends to a large degree upon income, the growth of which in Taiwan in turn depends on the export sector. Therefore it might be argued that if Taiwan's export sector had not grown at all over the past six years then economic growth would have been next to nothing. In this sense the lack of any growth in non-manufacturing investment indicated by Chart 4 is enough on its own to demonstrate that Taiwan's domestic economy has been extremely weak.

TAIWAN: CHART 5
THE COMPONENTS OF ECONOMIC GROWTH



TAIWAN: CHART 6
THE COMPONENTS OF ECONOMIC GROWTH



However, before a conclusion can be drawn it is necessary to ascertain the cause of weakness in domestic spending. It is quite possible that Taiwan's domestic economy has simply been 'crowded-out' by external demand i.e. that domestic demand is only weak because the current account surplus has become so large. 'Crowding-out' such as this can occur when the monetary authorities are attempting to maintain a stable rate of money growth - and hence nominal income growth - even as net exports are becoming increasingly large. Essentially, because the growth of national income is constrained by the authorities' stable monetary policy, then so is the growth of savings. If the savings/investment gap (i.e. the current account surplus) is widening, then by definition investment must be growing more slowly than income (or GNP) i.e. investment is 'crowded-out'. This phenomenon has been discussed in detail in previous issues of AMM with reference to Japan (see, for example, AMM Vol. 5 No. 5 and AMM Vol. 5 No. 6).

In Taiwan 'crowding-out' of the domestic economy is a particularly likely possibility because the authorities have attempted to maintain an exchange rate which is undervalued relative to purchasing power parity as a means of promoting exports, and have also attempted to maintain a constant rate of money growth. In economic theory controlling both the exchange rate (i.e. the price of money) and the quantity of money is usually thought to be impossible. However, the Taiwanese authorities are able to do this largely because of the array of regulations governing the financial system and the economy, potentially most important in this respect being strict foreign exchange controls which make the economy essentially closed to foreign capital. The government would like to liberalise foreign exchange controls and as a first step in early 1986 authorised five banks to offer international investment services through which Taiwanese citizens can invest in foreign financial assets. However, given the increasing problems posed by Taiwan's burgeoning foreign exchange reserves, the authorities' most recent move has been to tighten the regulations governing inward remittances. Since March 12th 1987 remittances by individuals have been limited to no more than US\$10,000, while for trade related remittances a maximum limit of US\$1 million has been imposed.

The importance of foreign exchange controls lies in the fact that they permit real interest rates in Taiwan to diverge from international levels, thus allowing control of both the exchange rate and money supply and permitting - potentially - crowding-out of domestic spending by the current account surplus. Because crowding-out of domestic investment implies a 'forced' reduction in domestic investment, it must imply a tendency for the marginal return to domestic investment to rise (i.e. as the number of investment projects is reduced those with the lowest return will be eliminated first, thus raising the return to the marginal project). If free capital movements are permitted this will not be possible because any tendency for the marginal return to investment to rise above the level of world real interest rates will attract capital from overseas. Thus, crowding-out will not occur but instead domestic investment will merely be financed from foreign savings and, given the managed exchange rate, there will be further upward pressure on foreign exchange reserves and the money supply arising from the capital inflow.

To better understand how the crowding-out of domestic investment might occur in Taiwan, it is helpful to examine the mechanisms through which the

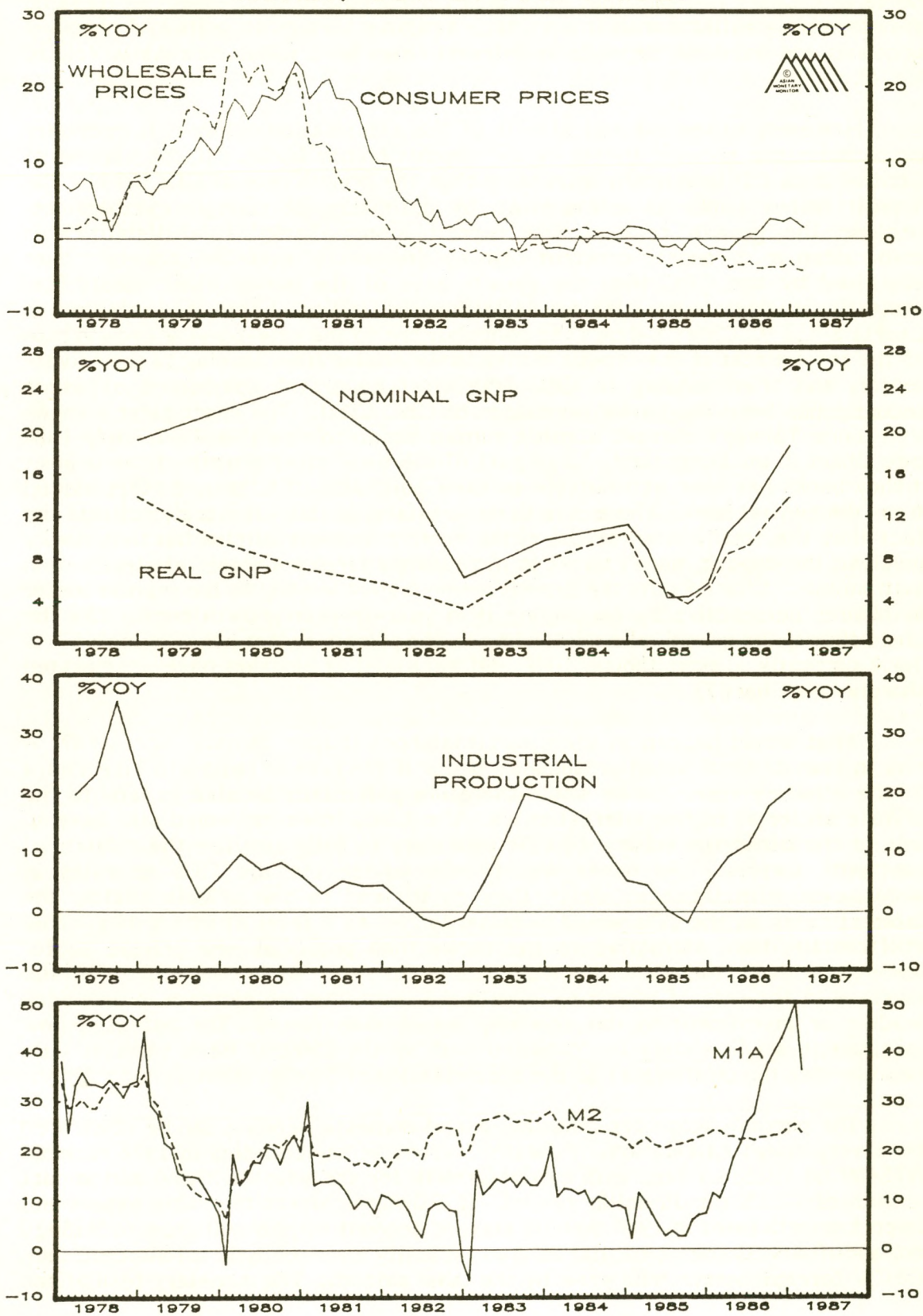
Taiwanese authorities control the money supply even while they maintain the exchange rate for the New Taiwan dollar at an 'undervalued' level and permit only limited capital outflows. This is simply achieved through massive sterilisation operations, by which the Central Bank of China (CBC) has made use of various sterilisation instruments - including central bank Certificates of Deposit, Treasury Bills 'B', Savings Bonds and the redeposit at the CBC of deposits from the Postal Savings System - to absorb liquidity from the private sector and hence offset the expansionary impact on the money supply of the huge balance of payments surplus. (See AMM Vol. 10 No. 1 and AMM Vol. 10 No. 5). In effect the CBC purchases the private sector's foreign exchange earnings not with high-powered money (which would involve crediting the deposit money banks' reserve accounts at the CBC) but with the various sterilisation instruments which, because they are not reserve assets, do not allow the banks to expand the money supply.

Over the past year the most significant sterilisation instrument has become Central Bank Certificates of Deposit (CDs). Deposits replaced by the Postal Savings System continue to grow because of the natural growth of postal savings deposits, but there is limited scope for the CBC to further raise the incremental redeposit ratio. The postal savings system is already required to re-deposit 70% of the deposits it receives from the public with the CBC (up from 35%), and yet postal savings system re-deposits also have to provide a major source of funding for the specialised banks, including the government-owned development bank, Bank of Communications. This necessarily limits the scope for further increases in the ratio for re-deposits with the CBC. Treasury Bills 'B' approached their legislated ceiling for issuance (determined as an amount equivalent to 25% of Central Government expenditure) in early 1986, meaning that CBC has not been able to increase the total of Treasury Bills 'B' outstanding since then. Although CBC has requested that this limit be raised to 40% of government expenditure, until such a time as this happens the Central Bank is forced to rely increasingly on issues of CDs.

Between February 1986 and February 1987 CBC issued nearly NT\$500 bn (US\$ 13 bn) worth of new CDs. The CDs are issued to the deposit money banks, ostensibly through auction. However, the deposit money banks, which for the most part are state-owned (more than 80% of the assets of the commercial banking system are held by deposit money banks which are majority owned by the Taiwan provincial government) tend to act as a cartel when tendering bids. The result is that the interest rate at which the CDs are issued tends to be above market and the issues are over-subscribed, and have to be allocated amongst the banks.

The volume of CDs issued by CBC will be whatever is necessary to keep the monetary base growing at a rate consistent with a stable rate of broad money supply growth. Thus, it will be primarily a function of the balance of payments surplus. If the balance of payments surplus grows larger, then the foreign assets of CBC will tend to increase more rapidly, and hence CBC will have to increase the volume of new CDs issued in order to prevent an acceleration in the monetary base. Thus, on the assets side of CBC's balance sheet foreign assets will be growing and on the liabilities side CDs outstanding will grow at a similar rate, while the monetary base remains unaffected. In itself, this then poses no problems for the central bank as indicated by its

TAIWAN: CHART 7
MONEY, OUTPUT AND PRICES



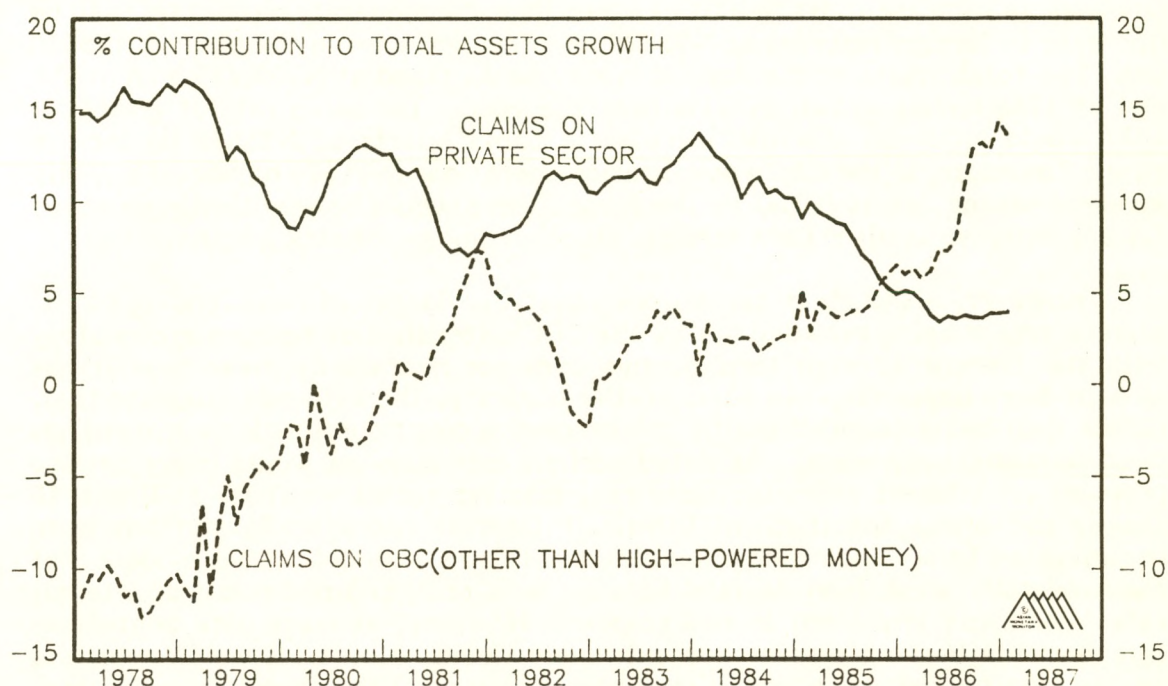
success in keeping the growth rate of M2 remarkably stable in the 20%-25% range (see Chart 7 - note that M1A is not important in this respect as its rapid growth merely reflects a shift from time and time savings deposits into chequing accounts and passbook deposits as interest rates have fallen, see AMM Vol. 10 No. 5).

However, to see the full effects of this sterilisation policy it is necessary to consider the balance sheets of the deposit money banks. If the volume of Central Bank CD issuance is increasing then the growth rate of CDs held by the deposit money banks as assets must, by definition, be rising. Furthermore, because the growth rate of the deposit money banks' total liabilities is constrained to a roughly constant rate by the control over the monetary base exercised by the CBC then the growth rate of the banks' other assets (i.e. domestic lending) must, also by definition, be falling. This is illustrated in Charts 8 and 9. Chart 8 shows the contributions to the year-on-year growth rate of the total assets of the deposit money banks arising from lending to the private sector, and from lending to CBC (the most important component of which recently has been the banks' purchases of CBC CDs). The chart clearly shows that since Taiwan's current account surplus began to rise sharply in early 1984 (see Chart 2) an increasingly large part of the total asset growth of the deposit money banks has been attributable to their purchases of CDs (and other assets) from the central bank. There is nothing surprising in this - it merely reflects the fact that the sterilisation of the rising current account surplus has necessarily involved the deposit money banks in increasingly large purchases of sterilisation instruments. Chart 9 puts the deposit money banks' lending to the private sector in clearer perspective by portraying it in year-on-year growth terms. As the chart shows, the growth of bank lending to the private sector has plummeted - to 5.6% currently - even though GNP and industrial production have accelerated sharply (see Chart 7).

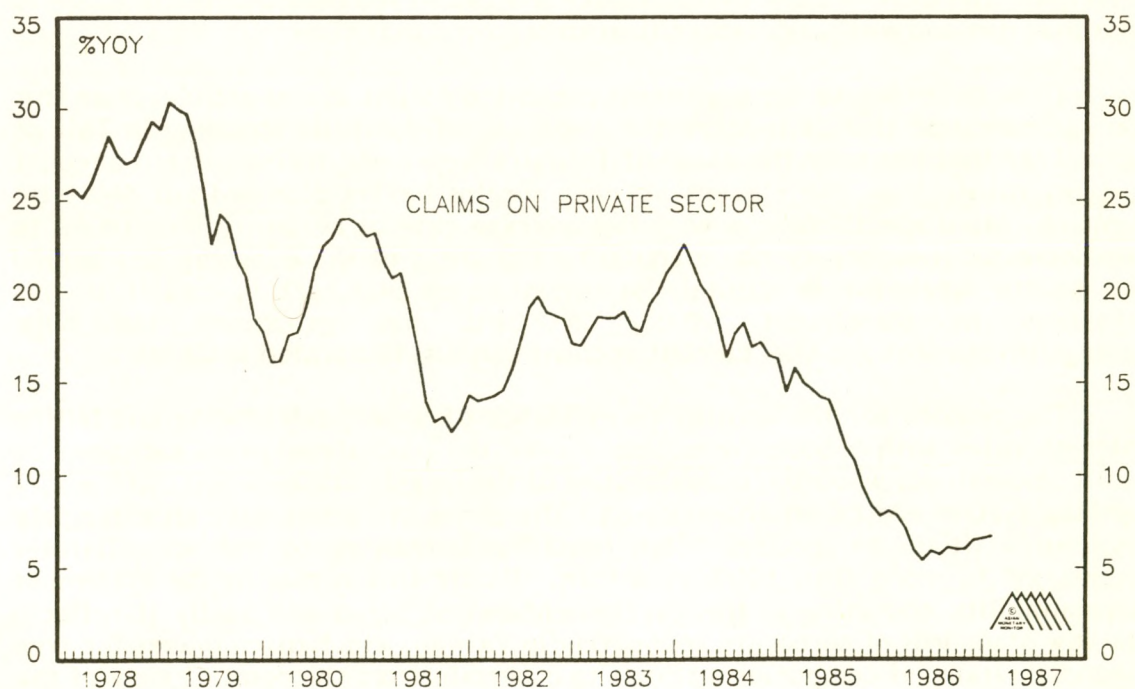
What would happen in these circumstances if loan demand increased? A rise in loan demand would presumably occur if the rate of return to investment in the economy rose. Banks would therefore potentially be able to lend to the private sector at higher interest rates. The CBC, however, would still have to sell to the banks the volume of CDs necessary to fully sterilise the balance of payments surplus. As banks would only tender for the CDs at rates in accordance with those at which they could lend to the private sector, the interest rates on the CDs would necessarily rise to a level at which they would still remain more attractive to the banks than potential new private sector lending. In short, the whole spectrum of interest rates would rise in line with the increase in the rate of return to investment, such that no increase in new bank lending or investment in the economy would take place. The potential new investment would simply be 'crowded out' by the Central Bank sales of CDs representing the counterpart to the accumulation of foreign assets.

The possible scope for crowding-out of domestic lending can be illustrated by a very rough calculation. Taiwan's current account surplus in 1986 reached NT\$609 bn (US\$16.1 bn), with export growth for the year of 29.6% and import growth of 17.3% (in US dollar terms). If Taiwan achieves the same export and import growth rates in 1987 then its current account surplus will grow to NT\$820 bn, and if we assume no capital inflows (actually an unrealistic assumption) then CBC's foreign assets will grow by the same amount. The monetary base at the

TAIWAN: CHART 8
COMMERCIAL BANK ASSETS



TAIWAN: CHART 9
BANK LENDING TO THE PRIVATE SECTOR



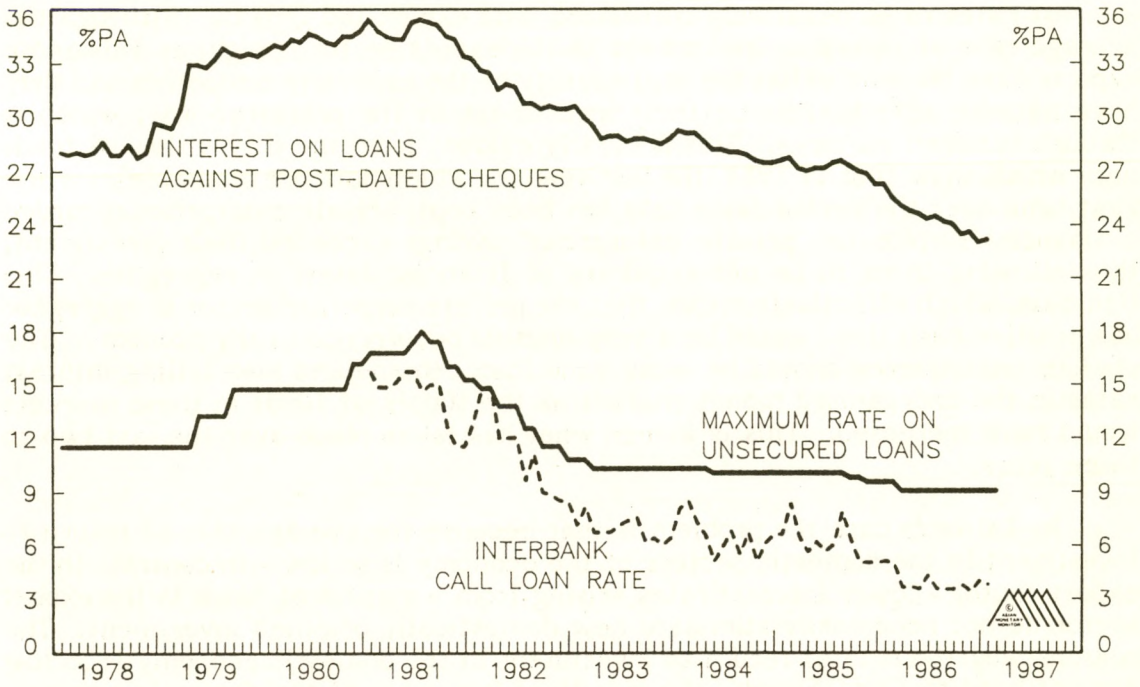
end of 1986 stood at NT\$516.8 bn, having grown by 29% over the year. To achieve the same rate of growth of the monetary base in 1987 - an absolute increase in the base of NT\$150 bn (0.29×516.8) - CBC would then need to engineer an increase in its liabilities other than the monetary base of NT\$670 bn (Increase in foreign reserves of NT\$820 bn minus increase in the base of NT\$150 bn). The total assets of the deposit money banks stood at NT\$3,289.9 bn at the end of 1986 having grown by 21% over the year. The same rate of growth in 1987 would imply an absolute increase in banks' assets of NT\$687 bn for the year. Therefore, if the CBC's sterilisation operations (NT\$670 bn above) entirely involved selling assets (CDs) to the banks, there would be practically no scope for any increase at all in bank lending, all other things remaining equal.

However, although it can be seen that the danger of bank lending to the private sector being crowded out by the CBC's sterilisation policies grows along with the current account surplus, this does not necessarily mean that it has already been happening. In fact, on the contrary, the evidence suggests that, rather than being crowded out by the current account surplus, loan demand has been fundamentally weak. As noted earlier, crowding-out would imply upward pressure on interest rates (actually real interest rates) whereas, as Chart 10 shows, the broad spectrum of (nominal) interest rates in Taiwan has been declining as bank lending has weakened. This is not conclusive evidence of fundamentally weak loan demand because it is real, and not nominal, interest rates which are important in this respect. However, at least until September last year the banking system was extremely liquid. Chart 11, which depicts a twelve month moving average of the excess reserves of the deposit money banks, shows that banks' reserve positions continued to ease up until late last year, while there was also anecdotal evidence of banks refusing to accept time deposits at that time because of an excess of liquidity. (This was another factor behind the public's switching from time deposits to demand deposits alluded to earlier, and which explains the rapid acceleration in M1A last year illustrated in Chart 7.) The ease of bank liquidity over the 1985-1986 period strongly suggests that loan demand was weak rather than strong over that time.

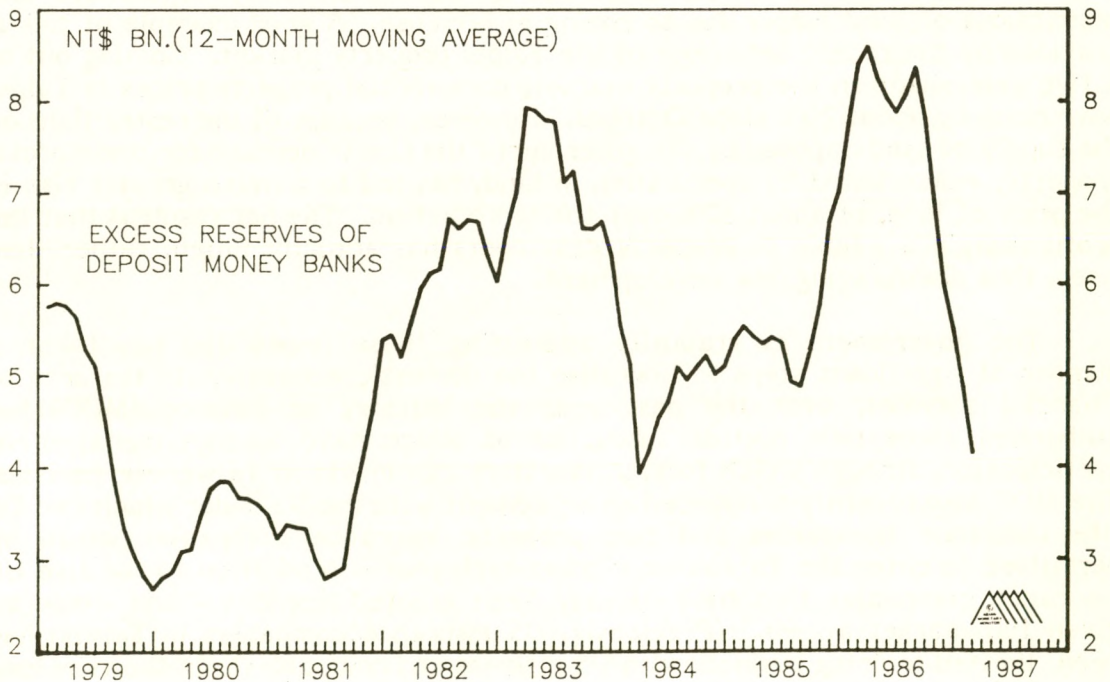
Thus, returning to the arguments presented earlier in this article, from this we can conclude that it is more the weakness of domestic spending in Taiwan since 1981 that has been the cause of Taiwan's huge and growing current account surplus, rather than the current account surplus having crowded out domestic demand. More specifically, a very low average rate of return to investment in the domestic (i.e. largely non-manufacturing) areas of the economy lies behind the severe weakness in capital formation noted in Chart 4, and it is this weakness in investment which, in turn, has generated the huge savings/investment gap (i.e. current account surplus) illustrated in Chart 3.

The reasons for the unusual co-existence of weak bank lending and falling interest rates with a booming economy over the past three years can then be easily understood, when the inflexibilities of the largely state-owned commercial banking system are taken into account. The banks in Taiwan take an extremely cautious attitude to lending, often requiring borrowers to put up collateral equivalent to more than 100% of a loan. Partly this is due to the system of accountability operating in the government-owned banks and partly it reflects the low standards of corporate accounting in Taiwan, which often makes the true financial state of companies difficult to ascertain from the point of view of the

TAIWAN
CHART 10: INTEREST RATES



TAIWAN : CHART 11
EXCESS RESERVES OF COMMERCIAL BANKS



lender. The net result is to make bank loans often difficult and costly to obtain for small companies, and is the reason for the thriving unorganised money markets in Taiwan. Given this it is reasonable to expect bank loan demand and interest rates to be negatively correlated with export-led growth. Although the average rate of return to investment in the export sector is high, as Taiwanese exports have boomed so has the profitability of the exporting companies and they have become able to finance their investment in the preferred way, which is through retained earnings. This is clearly evident from the CBC's flow of funds data which show that in 1985 (the last year for which data are available), for the first time over the period since data has been kept, private enterprises recorded a financial surplus i.e. private enterprises' savings exceeded their investment, thus allowing them to be net acquirers of financial assets in aggregate. This situation, which effectively means that the private corporate sector in aggregate has positive cash flow, would be a very unusual occurrence in any economy. The obvious consequence should be weak bank loan demand and also falling interest rates in the unorganised money market as the supply of funds in these markets would have increased. This is indeed what has taken place over the last two to three years.

In Taiwan's case the problem is that because the average rate of return to investment in the domestic sectors of the economy is so low - in contrast to the export sector - lower interest rates arising from a surplus of funds in the export sector do not necessarily stimulate new domestically oriented investment. The reasons why the rate of return to investment in the domestic economy is so low are not hard to find. Simply, the growth of key areas of the domestic economy e.g. wholesale and retail trade, property development, financial services, is suppressed as a result of government regulations and restrictions. The growth of the consumer/retail area has been depressed by high tariffs on imports of consumer goods while strict regulations govern the financial sector, particularly with regards to foreign entry, which is heavily restricted in banking, insurance and investment. Property development is also hindered by regulations and restrictions on land supply due to zoning of land use. A good example of this is provided by the recent behaviour of the Taipei property market. Coming out of a five year slump in the property market, commercial property prices in Taipei have risen by about 20% since October. However, because of the restrictions on the supply of land imposed by the government the rise in demand for commercial property, exacerbated by speculation in land, has led to a much greater rise in the price of land, of about 80% over the same period. The net result is that the profit margin available to property developers has actually fallen, rather than risen, thus discouraging new development.

The government is gradually addressing these issues and has taken a number of significant steps to liberalise the domestic economy. In the area of financial services, over the past year the Ministry of Finance (MOF) has authorised three new mutual funds, all of which have foreign management participation, through which foreign investors can invest in Taiwanese equities. The MOF also recently announced an agreement with the US under which two US life insurance companies and two property insurance companies would be permitted to enter the Taiwanese market each year - in addition to the five US insurance companies that have already been granted licences - and would be given full market access. (Previously, US insurance companies in Taiwan had been limited to doing business with US citizens and companies). In the very long

run the liberalisation of the insurance market could have a significant positive effect for domestic spending in Taiwan. In the past the absence of soundly managed insurance companies, when taken together with the only very limited social welfare system, has often been pointed to as the major reason for the very high personal savings ratio, because in the absence of insurance families are constrained to holding a high level of precautionary savings. Unfortunately, the prospects for major liberalisation of the banking system appear less good, as the commercial banks are owned largely by the provincial government (as opposed to the central government) which is not keen to relinquish its control, limiting the prospects for privatisation.

More importantly for the short-term, this year the government has implemented genuine reductions in import tariffs. Tariffs on 1,700 products were reduced in January and a more significant package, implemented from April 18th, has seen tariffs on 862 key agricultural and consumer items reduced between 20% and 50%. Tariffs, currently ranging from 20% to 30% for consumer electrical products to 38% for cosmetics and 55% for buses, cars and trucks, are expected to be reduced much further over coming months and years. The government is also expected to reduce or eliminate other restrictive taxes, such as the domestic commodities tax which, for instance, results in the domestic price of cement produced by Taiwanese cement companies being more than double the export price.

These measures are clearly moves in the right direction, albeit comparatively limited as yet, to stimulating domestic economic growth. However, on their own they do not represent a coherent strategy for producing more balanced growth in the economy. As the earlier analysis suggests, even if the authorities do succeed in raising the rate of return to investment in the domestic economy through liberalisation they may only succeed in raising interest rates as domestic investment will necessarily be crowded out by the central bank's sterilisation of the balance of payments surplus. The government's current major policy for stimulating domestic spending - that of abandoning the usually very conservative fiscal policy and increasing government spending - could have worse repercussions in this respect. Because any government fiscal deficits will have to be largely financed through borrowing from the banks, leaving even less room for banks to extend credit to the private sector, government spending will directly crowd out private investment. There are already some very early signs of this process beginning, as local banks have been preparing to provide finance for major government spending projects - such as a new freeway - beginning in April/May. With domestic demand showing some signs of strength, as evidenced by the 20% rise in residential and commercial property prices since October, banks' reserve positions have become tighter (see Chart 11) and interest rates in the interbank market have very recently (i.e. in mid-April) begun to edge up.

One simple way out of this predicament would clearly be for the CBC to abandon its policy of fully sterilising the monetary effects of the foreign exchange build-up and to allow the money supply to expand more rapidly. This would simply be allowing the usual fixed exchange rate adjustment process to work, and would ultimately mean that the trade surplus would be reduced as domestic demand rises and exports become less competitive because of higher domestic inflation. A better policy, which would avoid the domestic inflation

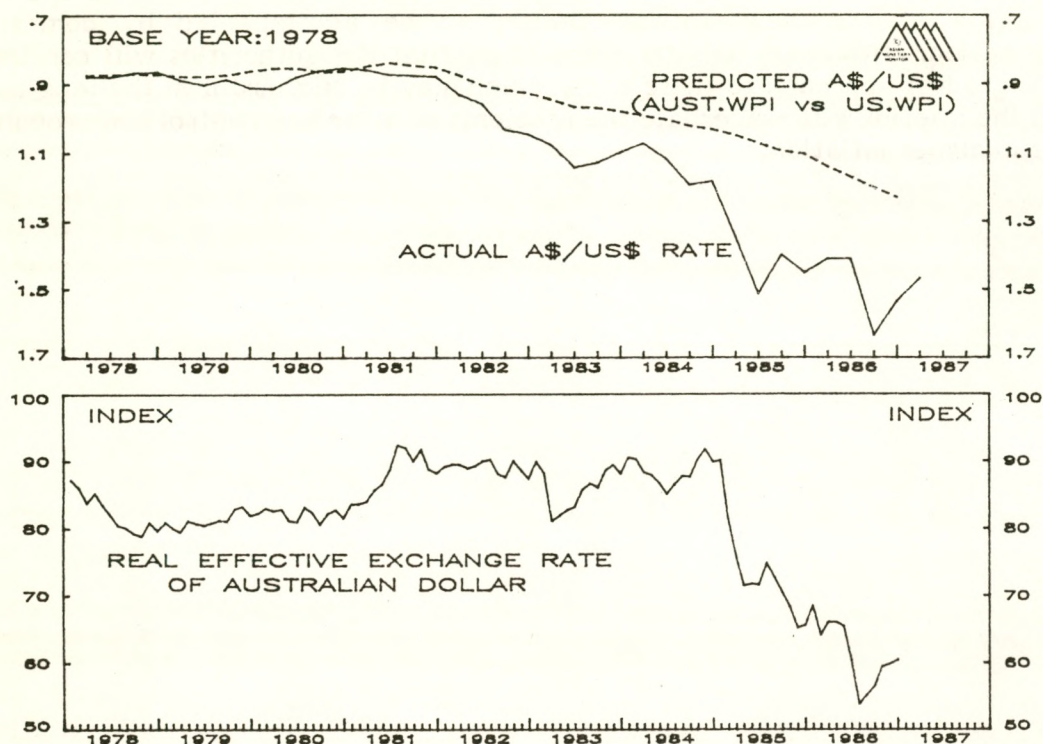
which the CBC is clearly trying to prevent, would be to revalue the New Taiwan Dollar. The CBC is already appreciating the New Taiwan Dollar and has raised its value by 22% against the US dollar since September 1985, with the rate of appreciation increasing rapidly in recent weeks. However, the policy of gradual appreciation of the currency has only encouraged massive legal and illegal speculation on further gains in the Taiwanese currency, which has made CBC's monetary control problem much more difficult. 'Legal' speculation largely comprises advance settlements of export contracts, and the financing of import transactions through extensive use of US dollar borrowings by importers. According to the CBC's balance of payments data these forms of currency speculation contributed to a short-term capital inflow of US\$1.5 bn in the second quarter of 1986, US\$2.8 bn in the third quarter and US\$3.5 bn in the fourth quarter, compared with an outflow of short-term capital in each of the years between 1982 and 1985. There is no doubt that this short-term capital inflow has become even larger in the first quarter of this year.

FORECAST: To summarise and conclude, the imbalanced nature of growth in the Taiwanese economy, featuring very rapid growth in net exports but marked weakness in domestic spending, is not sustainable for much longer. Largely because the domestic economy has been fundamentally weak - the result of a very low average rate of return to investment in the non-manufacturing sector of the economy, attributable to government regulation - the Central Bank of China has, over the past few years, been successfully able to control money supply growth even while maintaining the exchange rate for the New Taiwan dollar at an undervalued level. The CBC has been able to do this by selling increasingly large quantities of its own liabilities to the deposit money banks to sterilise the monetary impact of the growing balance of payments surplus. The deposit money banks in turn have willingly purchased this growing volume of CBC liabilities at ever lower interest rates because, as the exporting companies have moved into financial surplus on the back of the export boom, loan demand has been weakening. Demand for loans from the non-manufacturing areas of the economy has until recently remained exceptionally weak reflecting the very low average rate of return to investment in the domestic economy. However, there is now evidence that domestic demand is picking up, notably in the property sector but supported by increased government spending. The problem is that with the bulk of the savings of the private sector now being channelled, via the banks, into CBC liabilities required to sterilise the current account surplus, there is no real scope for any rise in domestic spending. Instead, stronger domestic demand would probably only result in higher interest rates.

It would be beneficial for the Taiwanese authorities to encourage, rather than stifle, any incipient improvement in domestic demand in order to improve living standards for the Taiwanese people. This is not even to consider the foreign - particularly US - political pressure currently being exerted on Taiwan. The appropriate policy would be to liberalise key areas of the domestic economy, the most notable being consumer, property and financial services. Some limited moves have already been made in this direction and further substantive measures should be implemented over coming months. However, stronger domestic spending will require a reduced current account surplus. The complete elimination of import tariffs would clearly go a long way to achieving a reduction in the current account surplus. A reduction in the surplus could in

addition be achieved in an inflationary way through the CBC relaxing its sterilisation policy. An economically superior way would be through a one-off revaluation of the New Taiwan Dollar, to be accompanied by domestic liberalisation. However, it is far more likely that the authorities will continue with a gradual approach to these ends, which may be successful in the long-run, but in the interim will exacerbate the problems of monetary control and probably result in higher inflation.

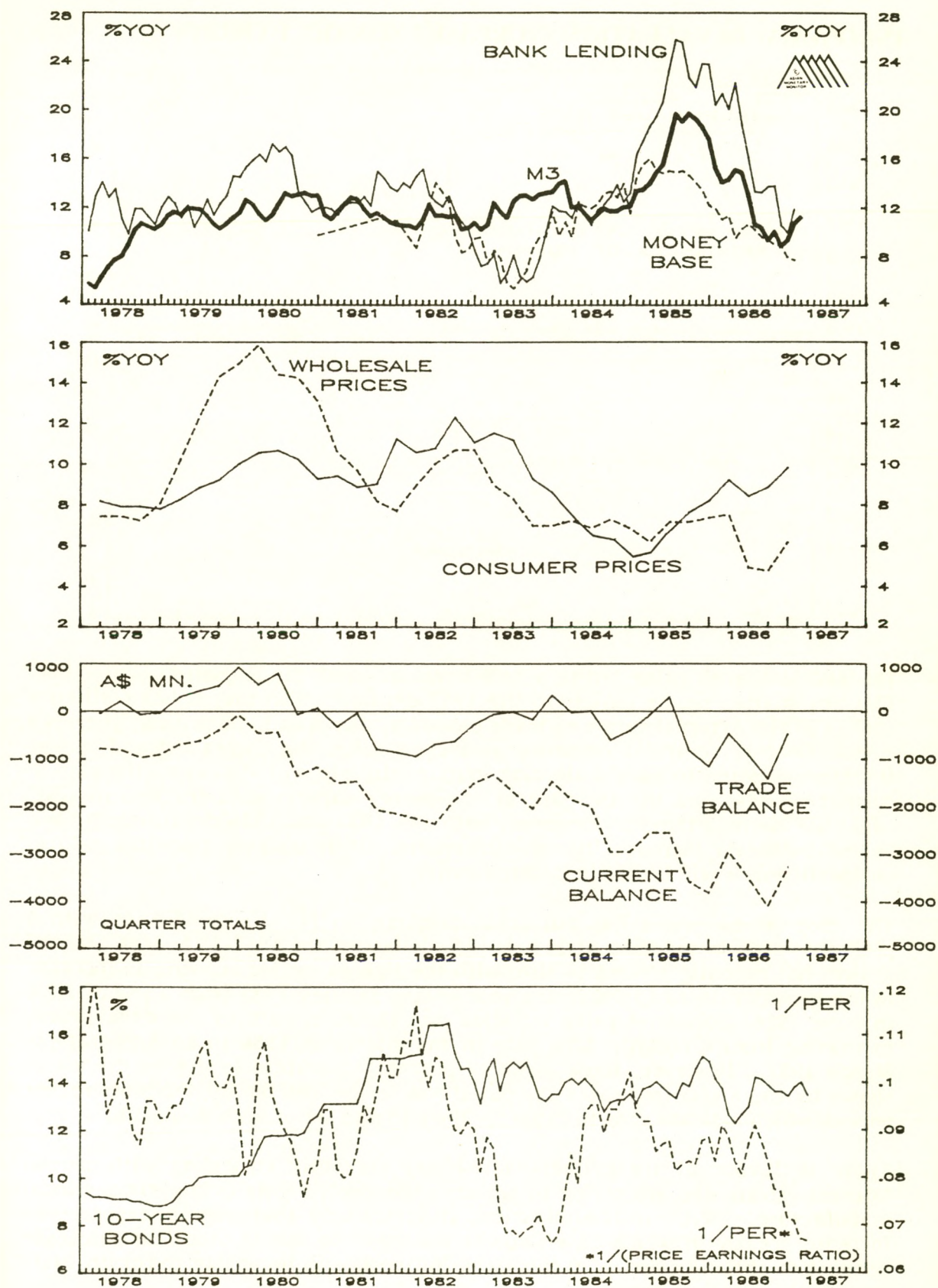
AUSTRALIA: A\$ APPRECIATION MAY HAVE BEEN OVERDONE



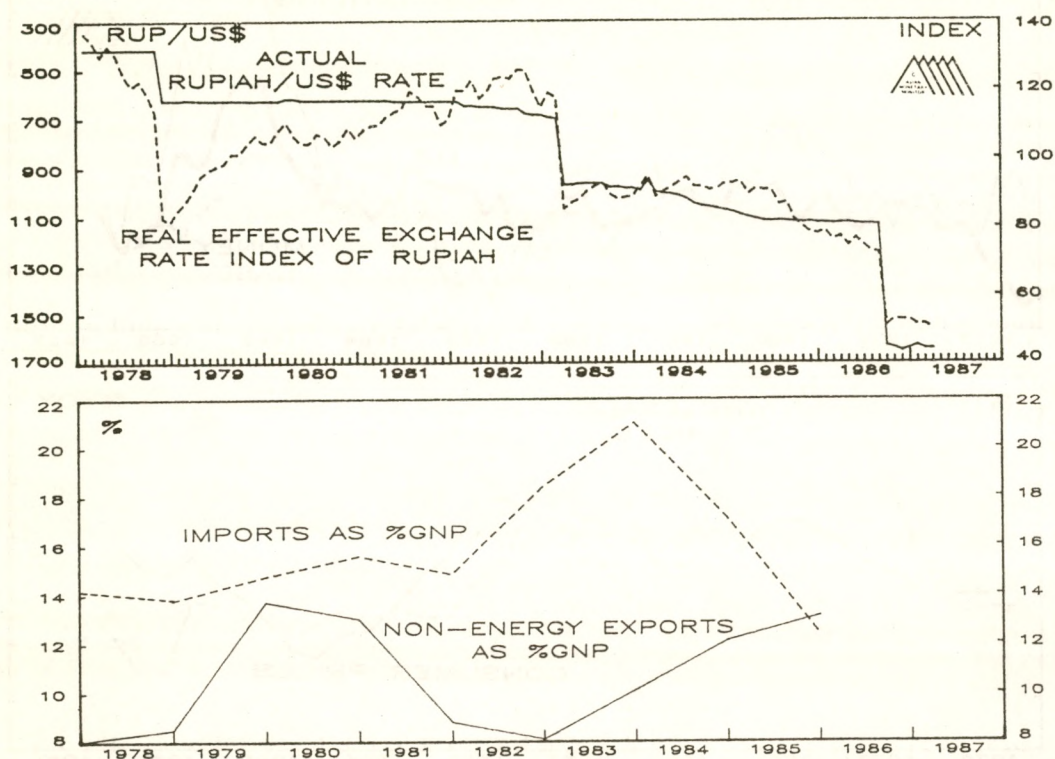
The Australian dollar has strengthened from its low of US\$0.60. Given the large external debt, equivalent to 34.2% of GNP, and low external prices for most exports except the precious metals, Australia will have to maintain its currency at undervalued levels relative to purchasing power parity. The recent currency strength is due to last year's oversold condition, the higher real price of gold and other exports, and growing confidence that the Reserve Bank will intervene in order to maintain strength in the currency, especially as measured by the trade-weighted index. However, Australia's inflation rate continues above that of its trading partners, and recent labour settlements of about 7%-8% have done little to diminish inflationary expectations.

While the monetary base has been on a declining path, falling from 16% growth in March 1985 to 7.7% recently, both M3 and bank lending have shown increased growth rates of 11.2% and 11.9% respectively. This combination normally implies that the Reserve Bank is following a restrictive policy, with positive effects for the exchange rate. The strong A\$ has increased the incentive to foreign buyers of Australia's debt, thereby lowering interest rates.

Both the current account and the trade account have shown recent improvement, with a negative current balance of A\$750 million in February. The major danger to the economy still comes from the external sector. With labour settlements on the high side and the currency strengthening, Australia could easily inflate away its gains in competitiveness, especially if the rest of its export prices do not improve along with the gold price. Then the currency would fall, interest rates would rise, and the authorities would either have to accept inflation and currency depreciation or else be forced into a contractionary monetary policy.



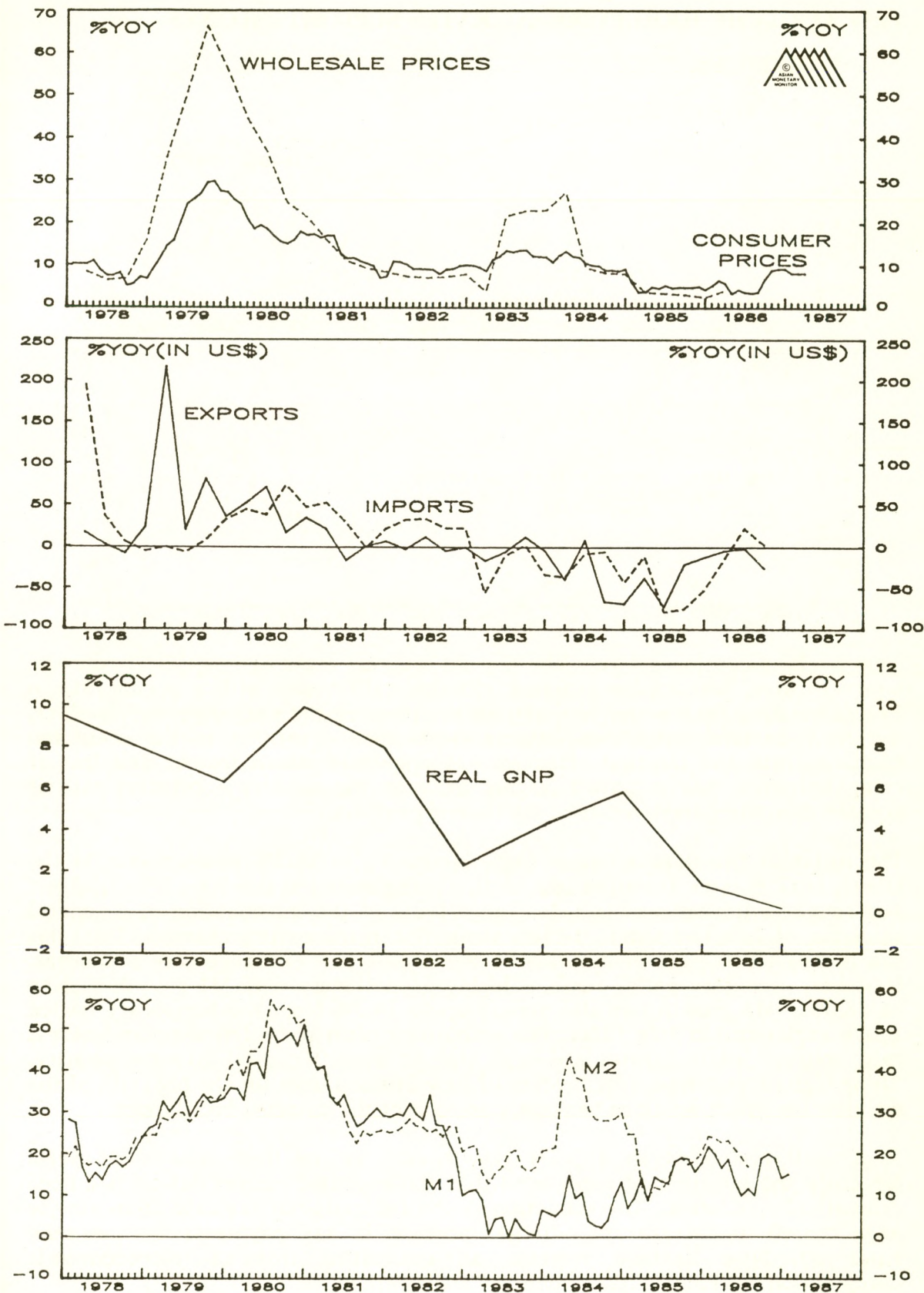
INDONESIA: DEVALUATION INCREASES NON-OIL EXPORTS



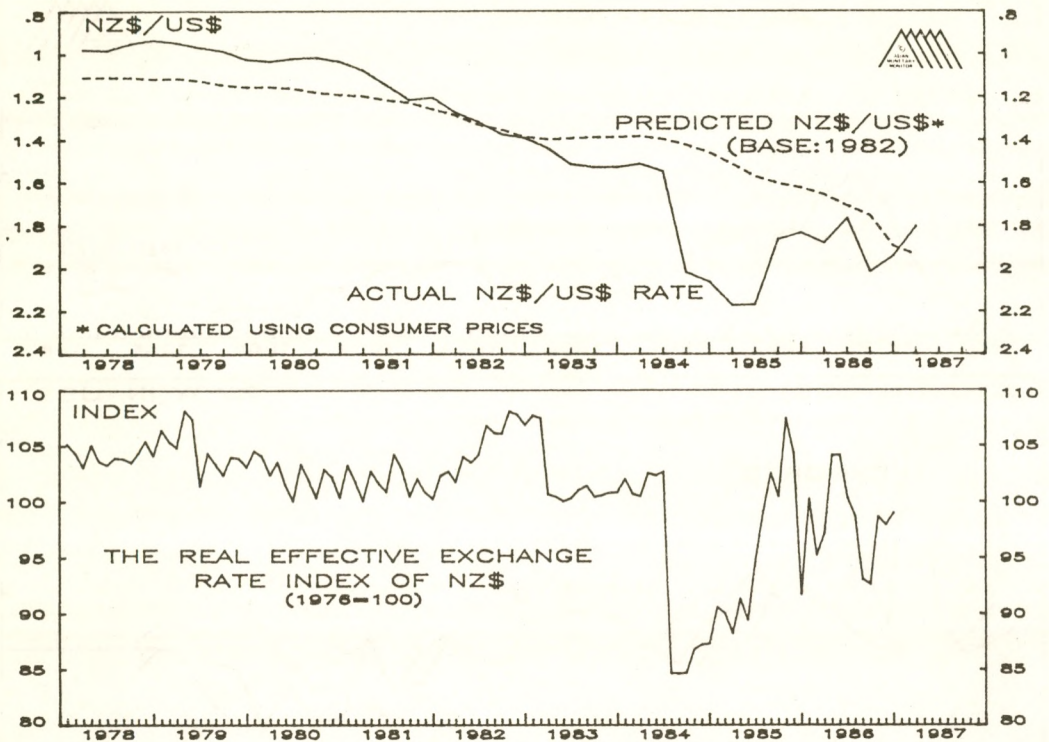
The fall in the oil price led to a 31% devaluation of the Rupiah in September. This devaluation seems similar to the 1983 devaluation in that it has ratified a change in the external terms of trade caused by the drop in oil prices. The 1978 devaluation, in contrast, occurred as the oil price was increasing and it was therefore doomed to have a fleeting impact. Inflation eroded away the gain in competitiveness and the increase in non-energy exports as a fraction of GNP could not be maintained. However, both the 1983 and 1986 devaluations have helped Indonesia increase its non-oil exports. It is unlikely that this gain in competitiveness will be easily inflated away.

The drop in oil prices has put great pressure on fiscal expenditures with a projected drop in spending of 26% in U.S. dollars in the 1987-88 budget. Money growth has recently tended to rise, with the figures for M1 showing an increase in the growth rate to 15.0% in the year ending January 1987 from a low of 9.8% in June 1986. Consumer price inflation was jarred upward by the devaluation, increasing from a roughly 3.5% rate in the middle of 1986 to an 8.1% rate in March 1987. However, these numbers probably overstate long term trends as shown by the annualised rates computed quarter-on-quarter for the most recent period, which indicate growth rates for the CPI and M1 of 2.2% and 5.1%.

Those in favour of trade liberalisation are currently struggling with special interest groups who are trying to preserve monopoly rights in imports and local manufacture. Without liberalization, it is unlikely that non-oil exports can increase greatly in which case imports will have to fall in order for the trade account to obtain balance. In this case, Indonesia will be unable to return to its previous high growth rates.



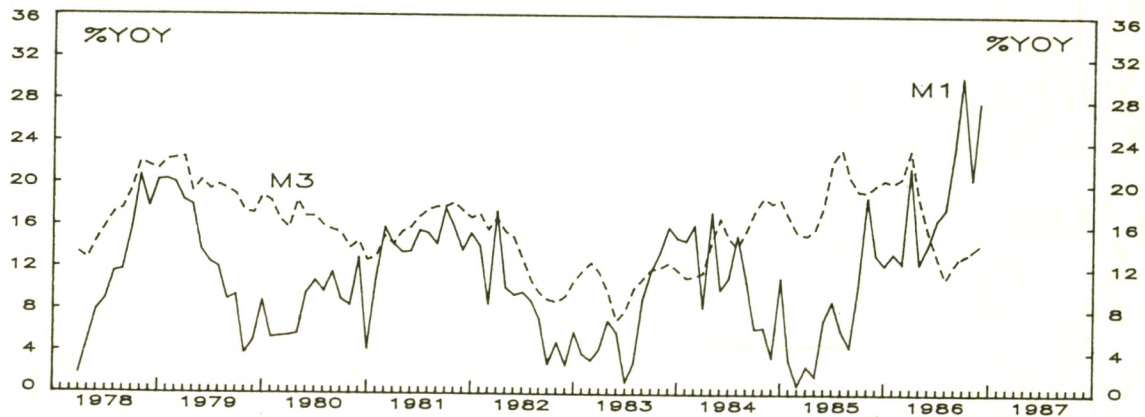
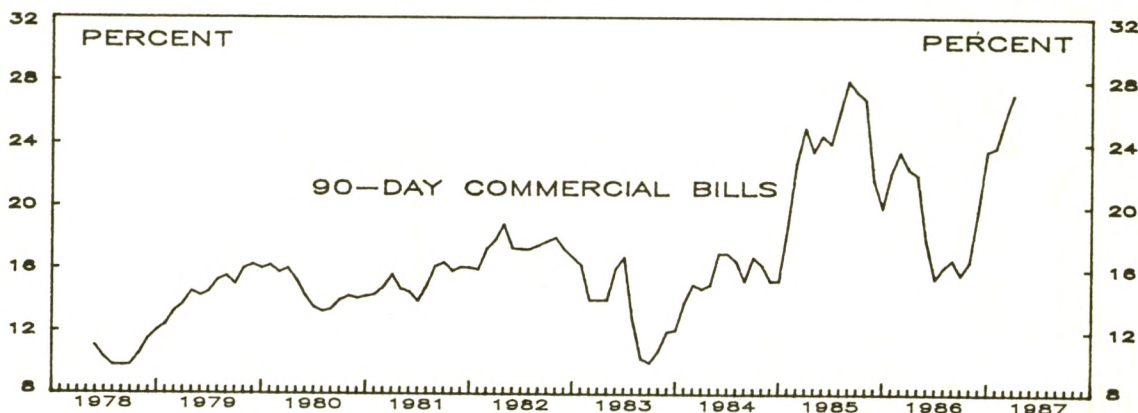
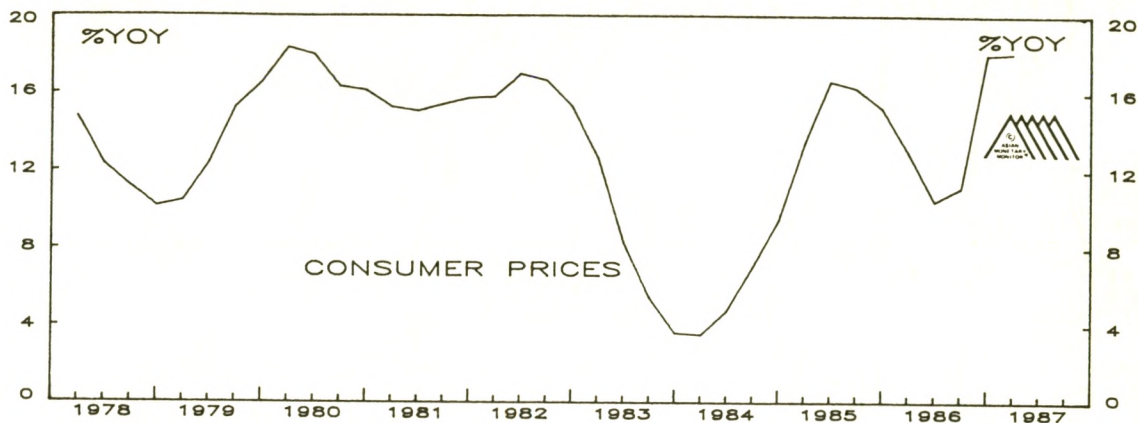
NEW ZEALAND: HIGH INTEREST RATES SUPPORT THE NZ\$



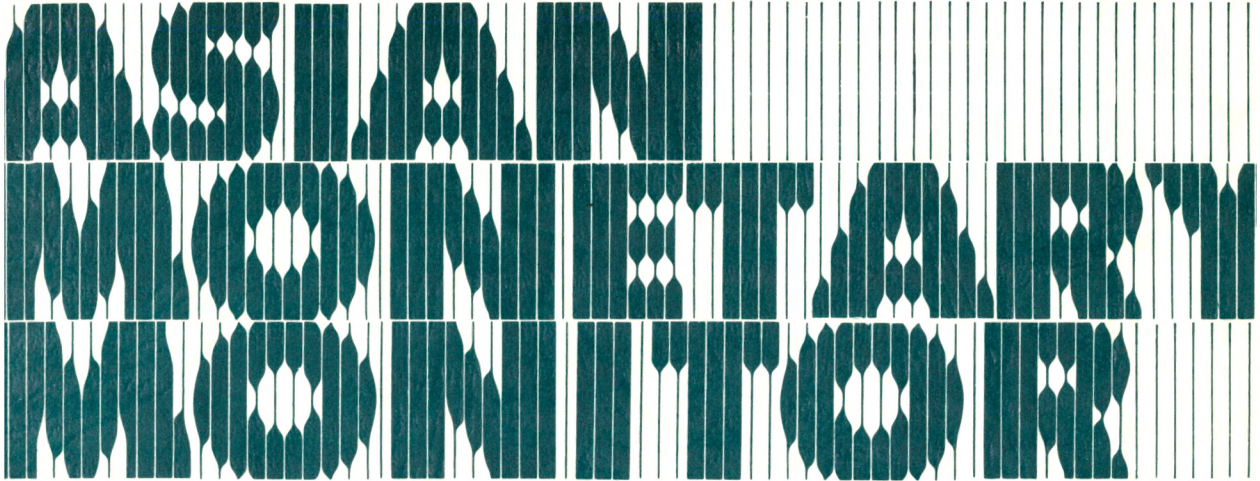
New Zealand continues to run the highest interest rates of any OECD country. Interest rates, which have reached 35% for call money with a prime rate in excess of 20%, have acted to maintain the level of the exchange rate. In fact, the New Zealand dollar has become overvalued according to the predicted exchange rate and the real effective exchange rate shown above. This loss of competitiveness has occurred largely because the country's inflation rate is greater than the inflation rate of its trading partners.

The inflation rate has remained high, increasing to 18.3% year-on-year in the March 1987 quarter from the low of 10.4% registered in the June 1986 quarter. The recent inflation rate includes the effects of the introduction of a general sales tax of 10% and should decline somewhat in the coming months. The sales tax is also biasing the calculation of the equilibrium exchange rate somewhat. However, monetary policy remains highly expansionary with M1 growth soaring to 28.0%. M3 growth has also turned up to 14.3% from the temporary low of 11.0% registered in July 1986. The authorities seem to be following an interest rate policy. Interest rates are kept high to attract capital into the country. These high rates compensate holders of New Zealand debt for the high risk of the devaluation which would be necessary to correct the external imbalances.

Real GDP recovered to a 3.1% growth rate in the third quarter of 1986. Recently the government announced that the expected budget deficit had been dramatically reduced. The reduction in the top marginal tax rate from 60% to 48% caused an unexpectedly large increase in tax payments by the self-employed. New Zealand remains an interesting mix of microeconomic deregulation with ineffective monetary management.







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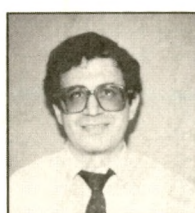
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JAPAN: THE INFLUENCE OF JAPANESE INSTITUTIONAL INVESTMENT BEHAVIOUR ON THE YEN-DOLLAR RATE

During March and April a change of investment policy by the major Japanese institutions had far-reaching effects for international financial markets, and interest rates and monetary conditions in both Japan and the US. The change occurred as the Japanese life insurance companies, trust banks and investment trusts sharply curtailed purchases of US government debt in favour of Japanese bonds. To some extent this institutional switch from US treasury bonds to Japanese government bonds was encouraged by Japanese accounting practices. The life insurance companies, in particular, became more wary of the foreign exchange risk inherent in purchases of US dollar bonds as unrealised foreign currency losses on their existing investments approached the threshold at which they would have to be reported in their annual accounts. Further, on March 1st the Ministry of Finance (MOF) revised the accounting regulations governing the 'Tokkin' accounts at trust banks, requiring them to report valuations of investments at the lower of cost or market value rather than purely at cost as previously, thus effectively requiring them to report losses. However, although these accounting conventions may have played a part in increasing the Japanese institutions' sensitivity to short-term losses on foreign investments, it is clear that the underlying reason for their shunning of the US treasury bond market in March was their increasing lack of confidence in the US dollar.

In the fourth quarter of 1986 estimated net purchases of foreign securities by the Japanese life insurance companies, securities investment trusts and trust accounts of banks totalled over US\$17 billion, effectively financing two-thirds of Japan's current account surplus for the quarter and possibly close to half of the US current account deficit. Although figures for March of this year are not available at the time of writing (except for investment trusts, which were net sellers of foreign securities) it is likely that this investment dropped to nearly nothing in that month. An indication of this is provided by the total private net long-term capital outflow in Japan's balance of payments, which fell to US\$8.74 billion in March, compared with a monthly average of US\$15.06 billion for the fourth quarter of 1986. Without the intervention of the authorities such a drying-up of the flow of capital from Japan to the US would, of course, have led to a collapse of the dollar. However, the Bank of Japan (BOJ) (and other world central banks) intervened heavily to maintain a stable yen/dollar exchange rate, thereby effectively replacing the lost private capital outflow with an official capital outflow. The increase in the BOJ's foreign exchange reserves (i.e. effectively Japanese official net purchases of US treasury bills) totalled US\$6.66 billion in March, US\$10.23 billion in April and US\$26.38 billion for the first four months of the year as a whole, while figures recently released by the New York Federal Reserve suggest that total official net purchases of US dollars by central

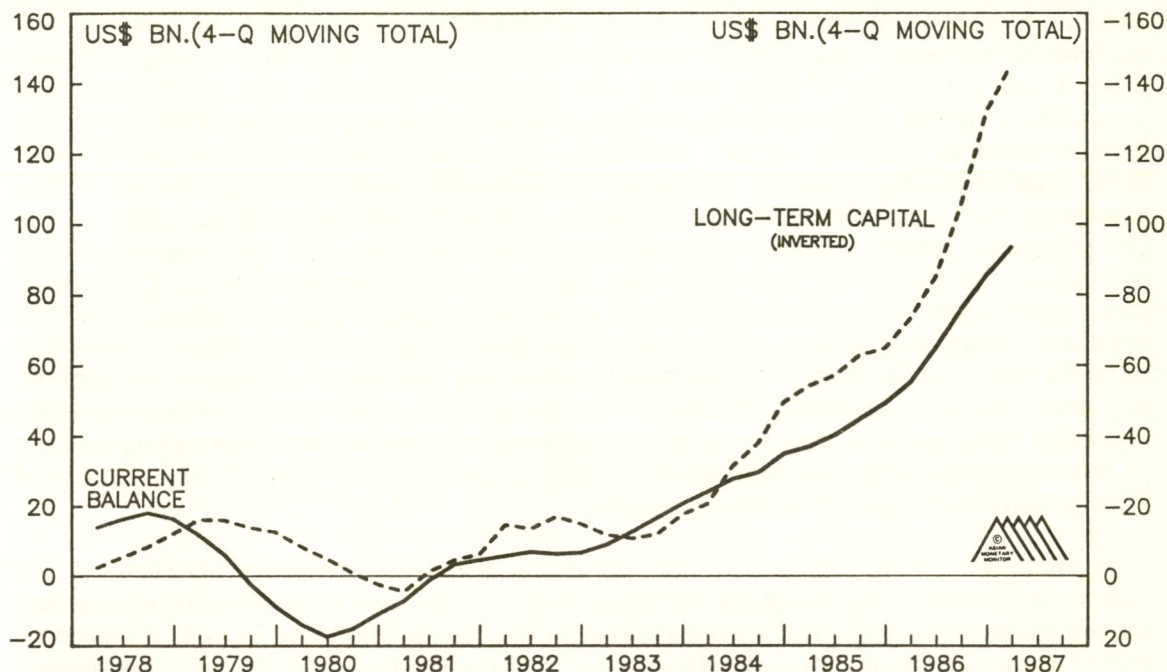
banks over February-April were roughly equivalent to the US current account deficit over the period. Thus, as a result of the sudden halting of US treasury bond purchases by the key Japanese institutions the world's major central banks, and particularly the BOJ, were forced to finance the whole US current account deficit.

Although the willingness of the central banks to continue financing the US current account deficit at the ruling exchange rate for the dollar necessarily prevented any sharp fall in the dollar's value, and although the central banks' purchases of dollars were largely sterilised, nevertheless significant consequences for interest rates and monetary policies in Japan and the US ensued. This was largely because the BOJ financed the official purchases of dollars by selling treasury bills issued to it by the foreign exchange fund of the Japanese government and then invested the acquired dollars in US treasury bills. Thus the BOJ's dollar support operation effectively increased the demand for short-term US government paper and increased the supply of short-term Japanese government paper, when the change of investment behaviour by the Japanese institutions which originally necessitated the central bank action had implied a fall in the demand for long-term US government bonds and a rise in the demand for long-term Japanese government bonds. The inevitable result was an opposing shift in the Japanese and US yield curves. The yield curve for US treasuries steepened markedly, the difference between twenty year bond and three month treasury bill yields rising from an average of 220 basis points over the November-March period to 350 basis points in May, the collapse in treasury bond prices feeding upon itself as the steepening yield curve and apparent vulnerability of the dollar further heightened inflationary expectations in the US. In contrast, Japanese long bond yields tumbled, the yield on the benchmark ten year bond falling from 4.8% at the end of February to under 3% in May, making the Japanese yield curve inverted. The BOJ, under pressure from the Japanese government and implicitly from the US administration, then felt constrained to 'correct' the inversion of the yield curve by bringing down short interest rates, easing monetary policy in the process. Partly as a result, in April year-on-year growth of M2+CDs, at 9.8%, rose to its highest level since 1982. Meanwhile, in the US, Federal Reserve Board Chairman Paul Volcker announced at the end of April that the Fed had moved to a "somewhat less accommodative policy reflecting in part the weakness of the dollar".

The events of March and April might therefore seem to suggest that the currency markets, and as a result monetary policy and interest rates in the US and Japan, are now a captive of the investment whims of the major Japanese institutions. Indeed in May, the Japanese MOF went as far as to summon the chief executives of the major insurance companies, securities houses and banks to warn them against selling US dollars, following this move with a request to the institutions to report their day-to-day currency positions. However, a careful examination of the trends of investment in foreign securities by the Japanese institutions shows that in their investment behaviour these institutions have in the past tended largely to be reactive to developments in international interest rates and currency markets, rather than instrumental in causing movements in the financial markets. In the rest of this article we examine trends in foreign securities investment by the major Japanese institutions in relation to Japan's overall balance of payments, and in relation to interest rate and currency movements.

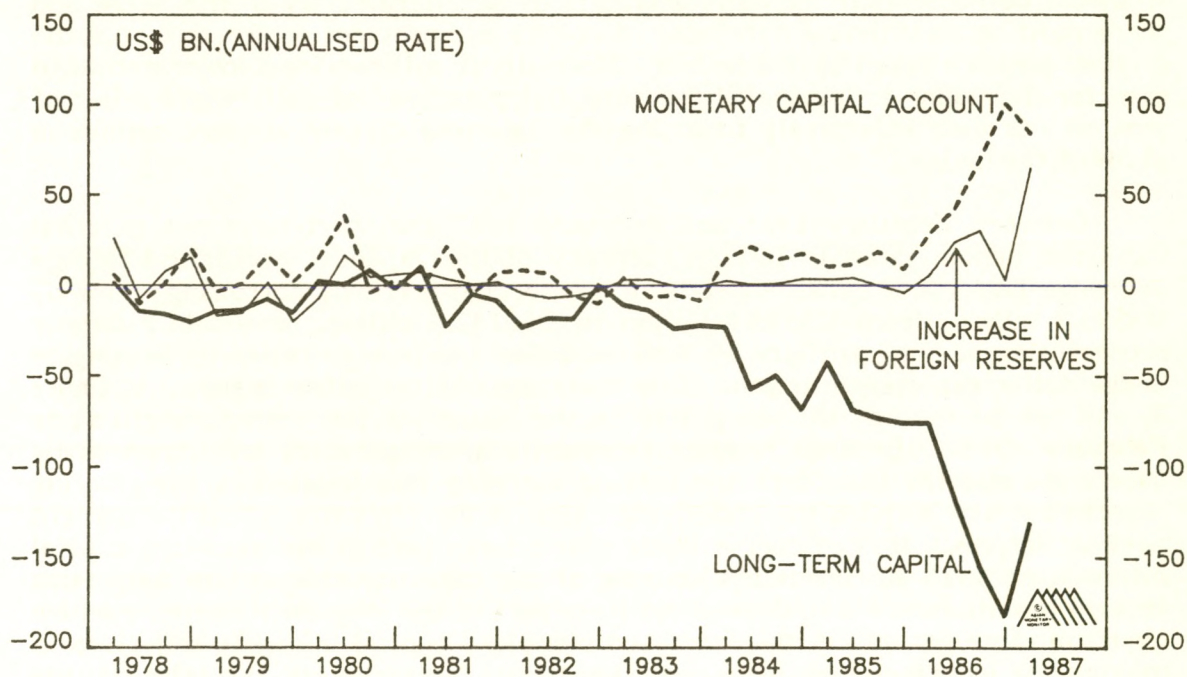
JAPAN: CHART 1

CURRENT AND CAPITAL ACCOUNTS OF THE BALANCE OF PAYMENTS



JAPAN: CHART 2

THE CAPITAL ACCOUNT OF THE BALANCE OF PAYMENTS



The basic developments in Japan's balance of payments during the 1980s were discussed in an article in AMM Vol. 10 No. 3, "Will the Yen Appreciation Correct the Balance of Payments Disequilibrium?" That article addressed the issue of causation in the balance of payments and suggested that the direction of the yen/dollar exchange rate is the key to deciding whether the capital outflow from Japan is 'causing' the current account surplus or the current account surplus is resulting in the capital outflow. The article suggested that prior to mid-1985 Japan's current account surplus had been generated as a result of growing long-term capital outflows from Japan which weakened the yen. Since mid-1985, however, the causation has been the reverse with the phenomenal strength of the yen suggesting that the growing current account surplus has been necessitating increasing purchases of US assets by Japanese investors only willing to make those purchases if tempted by lower and lower values of the dollar. As the article pointed out, and Chart 1 again illustrates, this is so even though there has been no observable change in the trend of the key elements of Japan's balance of payments since mid-1985. Rather, the change has been in the perceptions of currency risk, as Japanese investors in aggregate have become increasingly wary of the exchange rate risk embodied in their growing portfolios of US assets, and have sought to hedge US dollar exposure.

Japanese residents can hedge US dollar exposure either by borrowing US dollars and selling the proceeds of the borrowing for yen or by selling US dollars forward against yen in the forward foreign exchange market. In both instances, there is a short-term capital inflow into Japan although, certainly in the second case, it is likely to be monetary in nature (i.e. it will be in the form of an increase in the net foreign liabilities of the Japanese authorised foreign exchange banks). This is because the bank which 'takes the other side' of the forward contract will cover itself in the spot market by borrowing dollars and selling the dollars for yen or by selling an existing dollar asset for yen. However, it should be noted that the bank only acts as an intermediary in this sense and there must be an ultimate purchaser of dollars and provider of yen to match the original position taken by the hedger. Normally it will require a lower exchange rate for the dollar to 'persuade' the potential purchaser of dollars and seller of yen, who is then effectively financing the Japanese current account surplus in place of the hedger.

Between February 1985 and February 1987 the short-term net external liabilities denominated in foreign currency of the Japanese authorised foreign exchange banks (i.e. banks' short-term net foreign currency borrowing) grew by US\$93.2 billion, from US\$39.1 billion to US\$132.3 billion, presumably largely representing hedging activity by both Japanese and foreign residents wishing to hedge dollar exposure into yen. This monetary capital inflow is shown in Chart 2, and can be seen at the margin to be the 'cause' of the yen's strength since February 1985. (Because hedging represents a comparative unwillingness by Japanese residents to accept the foreign currency risk implied by the growing current account surplus, the underlying cause of the yen's strength is the current account surplus.) It is of course likely that a large part of the monetary capital inflow over 1985-86 represents hedging of the currency risk in new long-term foreign investments which themselves form part of the long-term capital outflow over the same period i.e. the increased monetary capital inflow to some extent mirrors the increased long-term capital outflow. Nevertheless, the extent of the increase in long-term capital outflows relative to monetary capital inflows

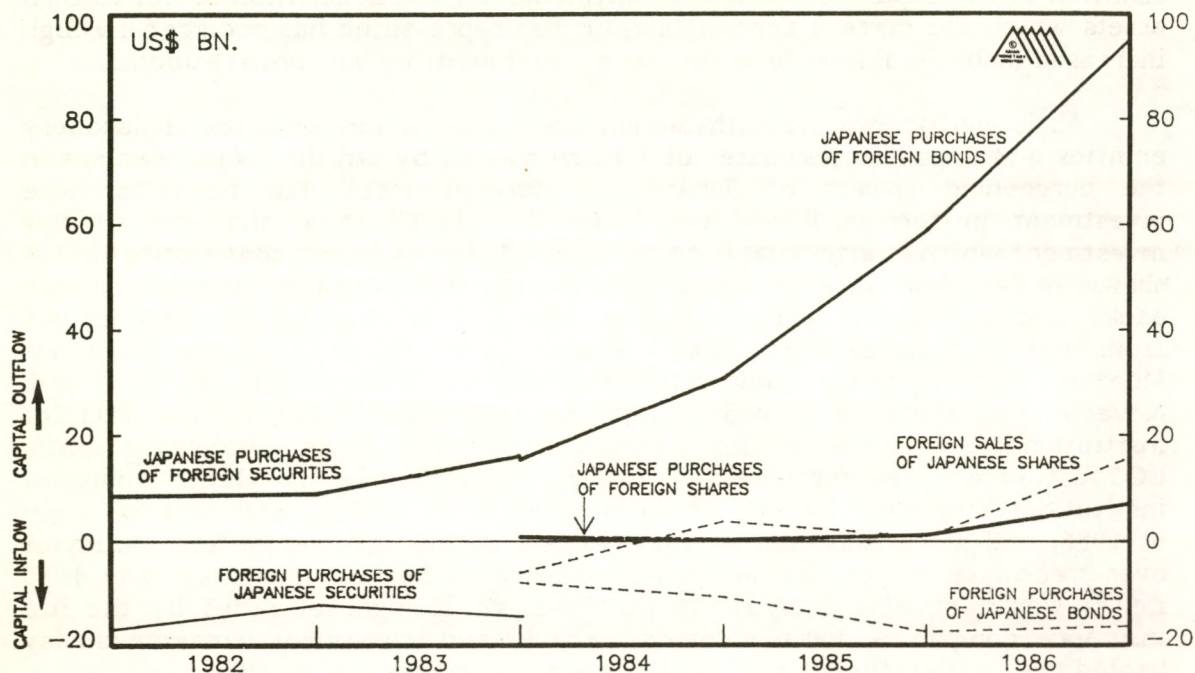
(Chart 2) and the current account surplus (Chart 1) makes it clear that it is unhedged long-term capital outflows which have performed the accommodating function in the Japanese balance of payments i.e. the acquisition of net foreign assets which the current account surplus has represented has occurred through increased (unhedged) long-term overseas investments by Japanese residents.

As is well known, notwithstanding some rise in foreign sales of Japanese equities and Japanese purchases of foreign shares, by far the major element in the burgeoning growth of Japan's net foreign assets has been Japanese investment in foreign bonds (see Chart 3). In Chart 4, the part of this investment which is attributable to the major Japanese investment institutions is shown, broken down into the three major groups - life insurance companies, trust banks, and securities investment trusts. The data for Chart 4 has been derived from monthly balance sheet data available in the BOJ's 'Economic Statistics Monthly', and possibly underestimates slightly the magnitudes involved. Nevertheless, the data accords closely with estimates made by the BOJ for institutional overseas securities holdings on an annual basis. According to the BOJ estimates, net purchases of foreign securities by the three groups of institutions accounted for half of the net long-term capital outflow from Japan in 1986, and more importantly, the increase in this investment accounted for over three quarters of the increase in the capital outflow compared with 1985 i.e. it was a massive increase in purchases of foreign securities by the life insurance companies, trust accounts at banks and investment trusts which lay behind the acceleration of the net long-term capital outflow in 1986.

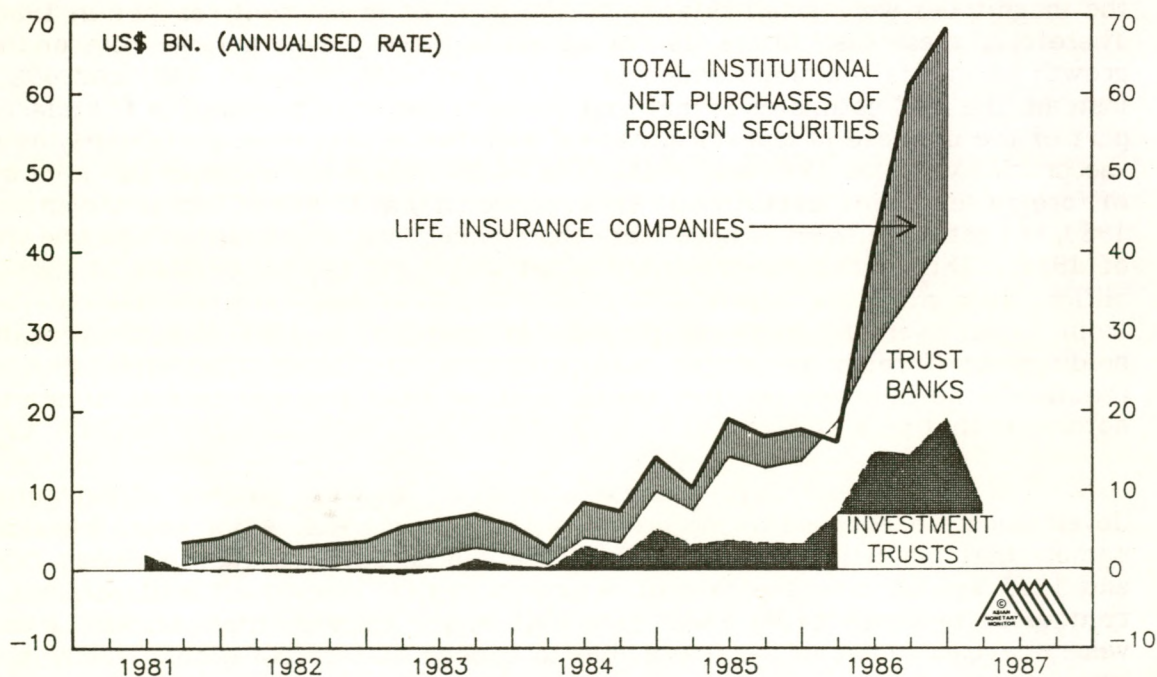
This is particularly evident from Chart 4, where the major point which emerges is that foreign securities purchases by trust accounts of banks, investment trusts and, most importantly, the life insurance companies, only really 'took off' in 1986. Before 1986 this investment had grown only slowly, and the magnitudes were small relative to the level of investment reached in 1986. Therefore, these institutions do not appear to have played a large role in the growth of capital outflows which kept the yen weak between 1981 and 1985. Instead, the BOJ estimates reveal that corporations were responsible for a large part of the increase in long-term capital outflows at that time, particularly over the crucial years of 1984 and 1985. The BOJ numbers place corporate holdings of foreign securities (exclusive of Tokkin accounts) at US\$19 billion at the end of 1983, but estimate them to have more than tripled - to US\$60 billion - by the end of 1985. This increase represented a net long-term capital outflow of US\$41 billion, accounting for nearly 40% of the total net long-term capital outflow from Japan over the two-year period. In contrast, in 1986 direct corporate holdings of foreign securities (i.e. exclusive of Tokkin accounts) showed practically no increase i.e. the capital outflow from this source fell to nearly nothing in that year.

This fits in neatly with the explanation of Japanese balance of payments developments expounded in the previous AMM article (i.e. AMM Vol. 10 No. 3), namely that the major reason why Japanese capital outflows grew between 1981 and 1985 was because the rate of return to capital investment in Japan had a continuous tendency to be lower than that in the US over that period. If this were the case it would be reasonable to expect that corporations, which in a sense are the economic agents whose decisions are the most directly affected by differences in rates of return to capital investment, would be increasing their

JAPAN: CHART 3
JAPAN'S INTERNATIONAL TRANSACTIONS IN SECURITIES



JAPAN: CHART 4
INSTITUTIONAL INVESTMENT IN FOREIGN SECURITIES

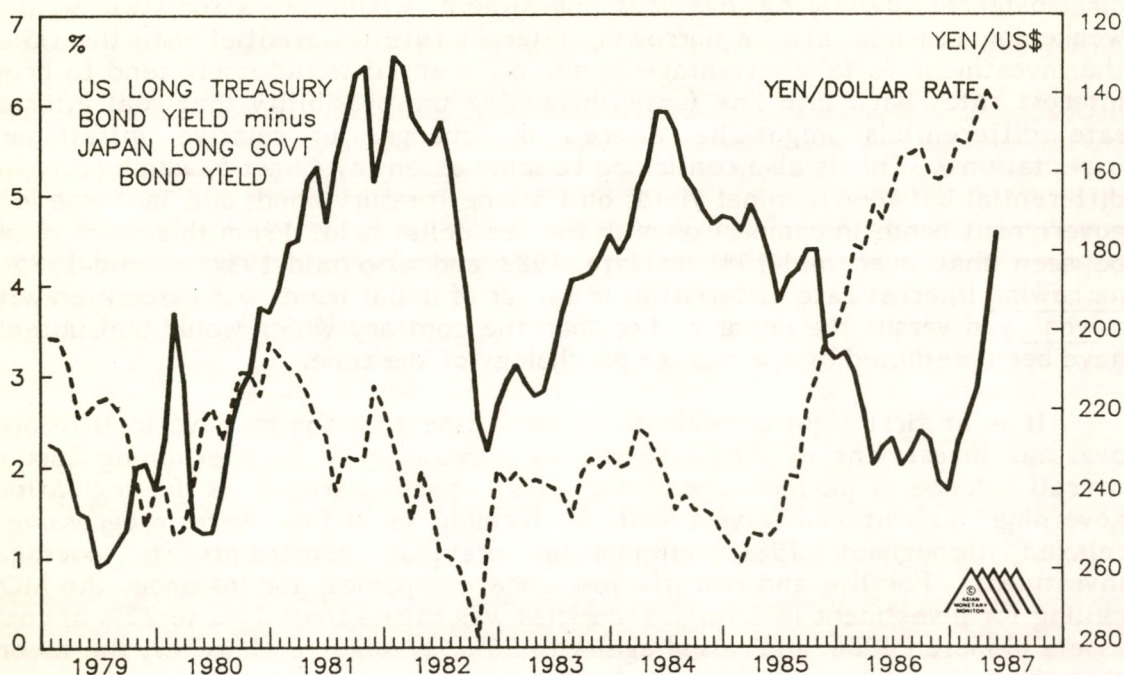


investment in foreign assets. The BOJ data seems to confirm this. Further, albeit much more tenuously, it might also be expected that under these circumstances increasing overseas investment would be associated with a weakening yen and, also, a narrowing interest rate differential with the US as the investment to take advantage of the differential would itself tend to bring interest rates back into line (notwithstanding the possibility that real interest rate differentials might be altered by changes in relative inflationary expectations). This is also confirmed to some extent by Chart 5, which plots the differential between nominal yields on US long treasury bonds and Japanese long government bonds in comparison with the yen/dollar rate. From this chart it can be seen that over mid-1981 to late 1982 and also mid-1984 to mid-1985 a narrowing interest rate differential in favour of dollar bonds was associated with a weak yen versus the dollar rather than the contrary which would undoubtedly have been predicted by the market psychology of the time.

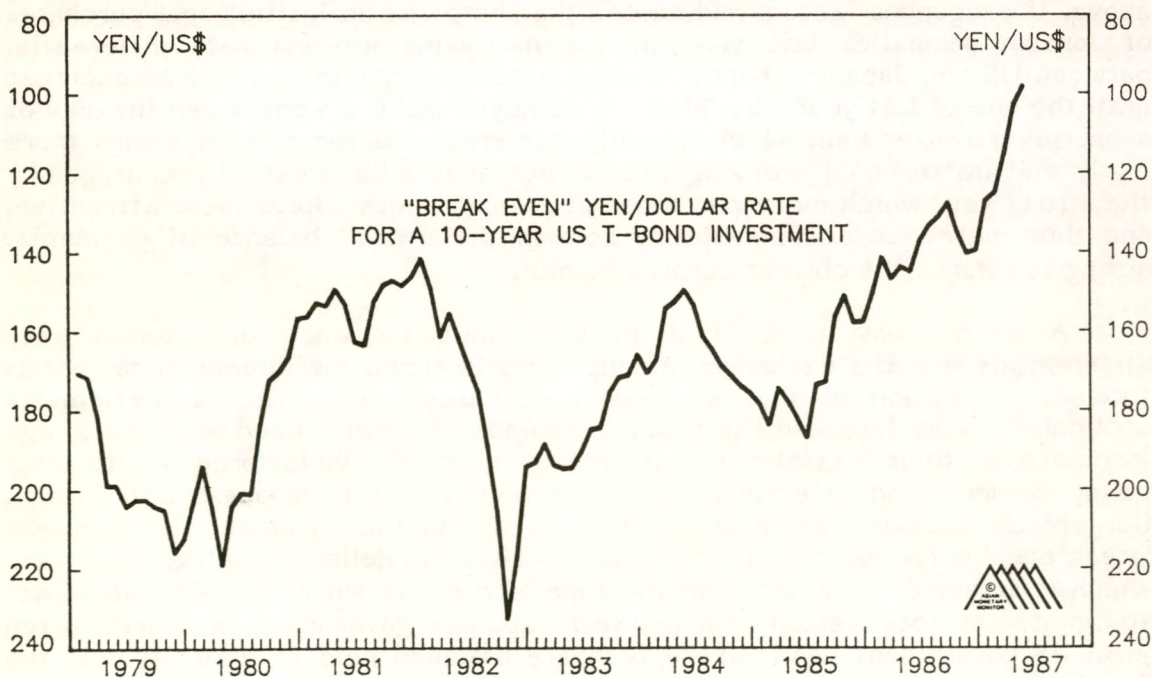
It is at first sight possible to make a case that the massive institutional overseas investment in 1986 also played a causal role in determining Japan's overall balance of payments position. This is particularly so as the regulations governing institutional investment in foreign securities were progressively relaxed throughout 1986, eliminating previous constraints to overseas investment. For life and non-life insurance companies, for instance, the MOF ceiling for investment in foreign securities was raised from 10% to 25% of total assets in March 1986, and raised again, to 30%, in August. However, the theory that the easing of regulations was behind the surge in institutional purchases of foreign securities in 1986 is not completely persuasive. Firstly, the regulatory constraints have rarely been binding. For instance, when valued on a cost of purchase basis, the foreign securities holdings of the life insurance companies stood at 8.7% of total assets in March 1986, and had grown to only 12.3% of total assets by February 1987. Secondly, and more importantly, as similarly argued above, if exogenous factors had caused the sharp rise in institutional purchases of foreign securities last year then a narrowing interest rate differential between US and Japanese bonds should have been expected (as indeed occurred until the end of last year), but also a tendency towards a weaker yen (instead of a sharply stronger yen, which actually occurred). Given this, it seems more likely that institutional overseas investment was to a large extent encouraged by the strong yen, which made purchases of foreign bonds appear more attractive, and thus played an accommodating role in the overall balance of payments, acting to finance the current account surplus.

A useful way to analyse the combined influence of interest rate differentials and the exchange rate upon institutional investment behaviour is through the notion of the 'break-even' exchange rate. This is particularly applicable to the Japanese life insurance companies, which need to derive a high income from their portfolio investments to match the yields promised to their policy holders, and effectively have a choice between Japanese and foreign (largely US treasury) bonds from which to obtain this income. The ten-year 'break even' exchange rate for the yen vis-a-vis the dollar is the exchange rate which if attained ten years from the time of the investment decision would act to equate the total return on a ten year Japanese government bond with a ten year US government bond, where both are assumed held to maturity. If the 'break-even' exchange rate for the yen is expected to be exceeded in ten years' time then (assuming a smooth appreciation of the yen) a yen bond investment

JAPAN: CHART 5
INTEREST RATE DIFFERENTIAL AND THE YEN/DOLLAR RATE



JAPAN: CHART 6
"BREAK EVEN" EXCHANGE RATE



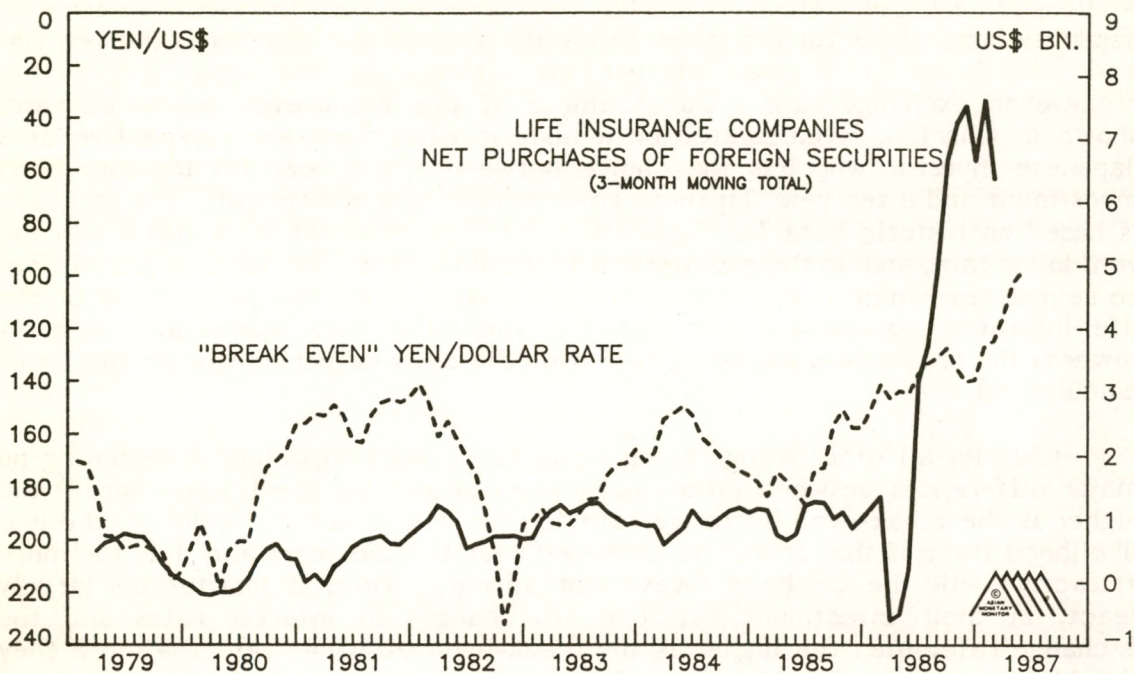
would yield a higher total return than a dollar bond investment over the period, but if the 'break-even' rate were not exceeded then a dollar bond investment would yield a higher return. Clearly, the higher are US bond yields relative to Japanese bond yields for any given yen/dollar rate or the stronger is the yen vis-a-vis the dollar for a given interest rate differential, the higher will be the break-even exchange rate. Our estimate of the 'break-even' exchange rate, shown in Chart 6, is calculated on a historic basis from the perspective of a Japanese investor who has the choice between a ten year US treasury bond investment and a ten year Japanese government bond investment. The estimate is based on historic data for Japanese and US government bond yields and the yen/dollar rate, and on the assumptions that income from the investment will not be reinvested (which is the appropriate assumption from the perspective of the life insurance companies) and that the yen/dollar rate appreciates linearly towards the break-even exchange rate over the ten year period (for simplicity of calculation).

Clearly, all other things being equal (and, most importantly, assuming no major differences between inflationary expectations for the US and Japan) the higher is the break-even exchange rate for the yen vis-a-vis the dollar, the less likelihood there is that it will be exceeded over the ten years and thus the more attractive will the US bond investment appear. Thus, if institutions largely react, in their investment decisions, to changes in interest rates and the exchange rate, then the higher is the break-even exchange rate the more they should invest overseas. However, if institutional investment decisions are the main factors causing interest rate and exchange rate movements, then the relationship should be expected to be the reverse. A sharp rise in institutional purchases of foreign securities as a result of exogenous factors (i.e. factors other than exchange rate movements) would then be expected to lead to a stronger US dollar and, possibly, a narrowing interest rate differential between US and Japanese bonds (as demand for US treasuries would be rising) and thus would be associated with a fall in the break-even yen/dollar exchange rate. Conversely, an exogenously determined drop in institutional demand for foreign securities would be associated with a rise in the break-even exchange rate. This latter could be a description of the events of March/April 1987 but, as Charts 7 and 8 illustrate, has not been the normal pattern of the historic relationship between Japanese institutional foreign investment and the exchange rate.

Charts 7 and 8 separately illustrate the net purchases of foreign securities by, respectively, the life insurance companies and the trust accounts at banks. Chart 7 is the most significant because it more clearly conveys the information also presented in Chart 4 - that a surge in purchases of foreign securities by the life insurance companies was the major element in the rapid rise in Japanese institutional overseas investment in 1986 and also a very important component of the acceleration in the overall net long-term capital outflow from Japan. As the chart indicates, prior to 1986 life insurance company investment in foreign securities held relatively constant, only rising very sharply last year. It is true that the relaxation of regulations governing this investment may have played a part in the explosion of foreign securities purchases, but it is more likely that the rise in the break-even yen/dollar exchange rate to levels significantly above most purchasing power parity forecasts for the yen vis-a-vis the dollar was the important influence. Thus the life insurance companies played a key role in financing Japan's burgeoning current account surplus, increasing their foreign

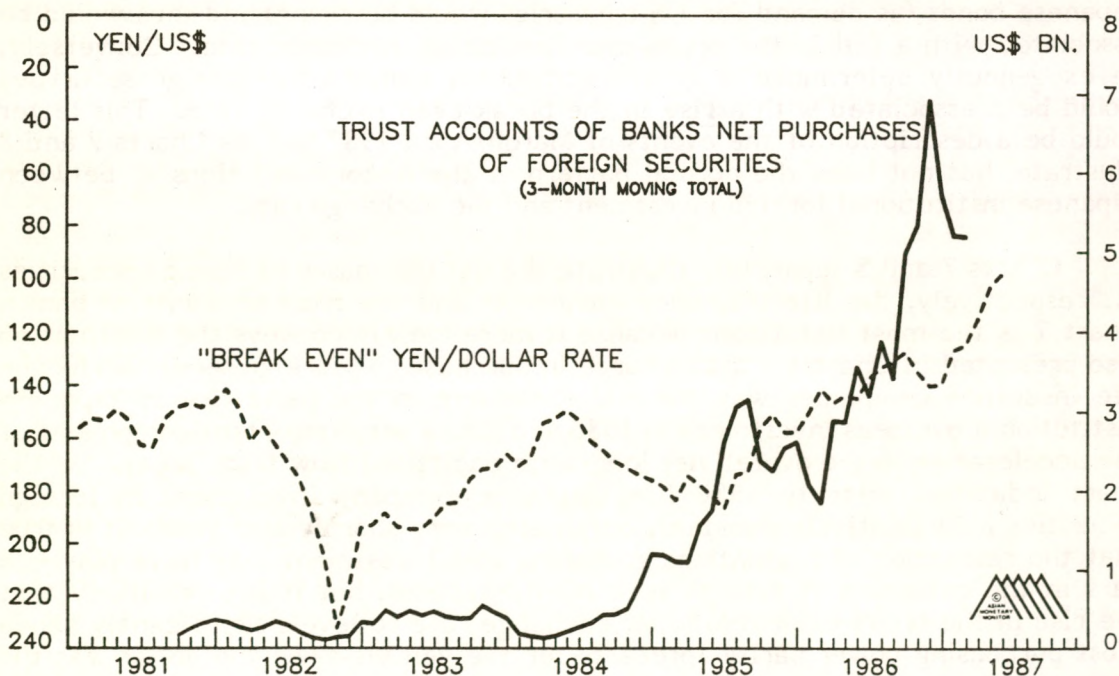
JAPAN: CHART 7

LIFE INSURANCE COMPANIES INVESTMENT IN FOREIGN SECURITIES



JAPAN: CHART 8

TRUST BANKS INVESTMENT IN FOREIGN SECURITIES



investment as the growing current account surplus drove the yen higher. In March 1987 it appears that their accumulating foreign exchange losses radically altered the life insurance companies' perceptions of the exchange rate risk inherent in US dollar investments, effectively meaning that the notional break-even exchange rate for the yen/dollar at which they would have been prepared to continue investing gapped sharply higher. The major central banks, however, were not prepared to countenance this exchange rate (whatever it might have been) and thus were forced to temporarily finance the Japanese current account surplus themselves.

FORECAST: To summarise, notwithstanding their visibility in US treasury bond auctions and the huge scale of their purchases of foreign securities, Japanese 'institutional investors' generally do not appear to have been a driving force behind developments in Japan's overall balance of payments and the external payments imbalance with the US over the period of the 1980s. Instead, net capital outflows which kept the yen weak for longer than was compatible with a smooth return to equilibrium on the trade account (over 1984-85), were largely attributable to direct purchases of overseas securities by corporations, while institutional purchases of foreign securities only began to rise sharply in 1986 when the yen was already strengthening rapidly. This point is clearly shown by BOJ figures, which estimate that institutional investors (ie insurance companies, investment trusts, trust accounts of banks) held 35%-36% of Japanese residents' total holdings of overseas securities over 1983-84, this figure falling to 31.7% in 1985. In 1986, the sudden sharp increase in foreign security purchases by the institutions saw the percentage of Japan's total holdings of overseas securities attributed to them rise sharply, to 41.3% by the end of the year.

Nevertheless, it is not correct to conclude from this that the Japanese institutions have no influence on the yen/dollar exchange rate. On the contrary, because at the margin the institutions have been responsible for financing the Japanese current account surplus and US current account deficit, it is their perception of exchange rate risk - as embodied by the likelihood that the yen will rise above the 'break-even' exchange rate for their chosen foreign investments - which determines the relative attractiveness of foreign investment to them and therefore in the short-term largely determines the exchange rate for the yen. Furthermore, because perceptions of currency risk often to a large extent depend upon the recent behaviour of the exchange rate itself, this clearly can create an unstable situation in the short-term, as was demonstrated in March and April. However, in the long-term perceptions of currency risk should largely be determined by trends in the current account of the balance of payments, meaning that the appreciation of the yen should tend to be a function of the speed at which the current account surplus is expected to narrow.

The above analysis suggests that, given the currently high level of the 'break-even' exchange rate, Japanese institutional investment in foreign (largely US) securities will likely resume at its 1986 fourth quarter pace once perceptions of exchange rate risk have diminished. The recent period of stability in the yen resulting largely from central bank intervention, should be sufficient to ensure this. A further factor contributing to a diminished perception of exchange rate risk might be the relaxation of regulations governing overseas security investment by the postal pension and insurance fund of the Ministry of Posts and

Telecommunications, which from June will permit the agency to increase the percentage of foreign investments in its total portfolio from 10% to 20%, and may therefore give rise to an 'exogenously determined' capital outflow (of potentially as much as US\$20 billion). However, for the longer term, the extent of the fall-off in Japanese institutional investment over March-April provides a clear indication of how far the US dollar could fall against the yen in the event of any further period of heightened perception of currency risk by the Japanese institutions. Furthermore, as the percentage of foreign currency assets in these institutions' total portfolios continues to increase these risks become more apparent. The simple conclusion must be that unless the trade imbalance between the US and Japan shortly begins to narrow significantly, a further 'dollar crisis' will be inevitable.

MALAYSIA: DEREGULATION AND PRIVATISATION GATHER MOMENTUM, BUT THE BANKING SECTOR LAGS BEHIND

Introduction

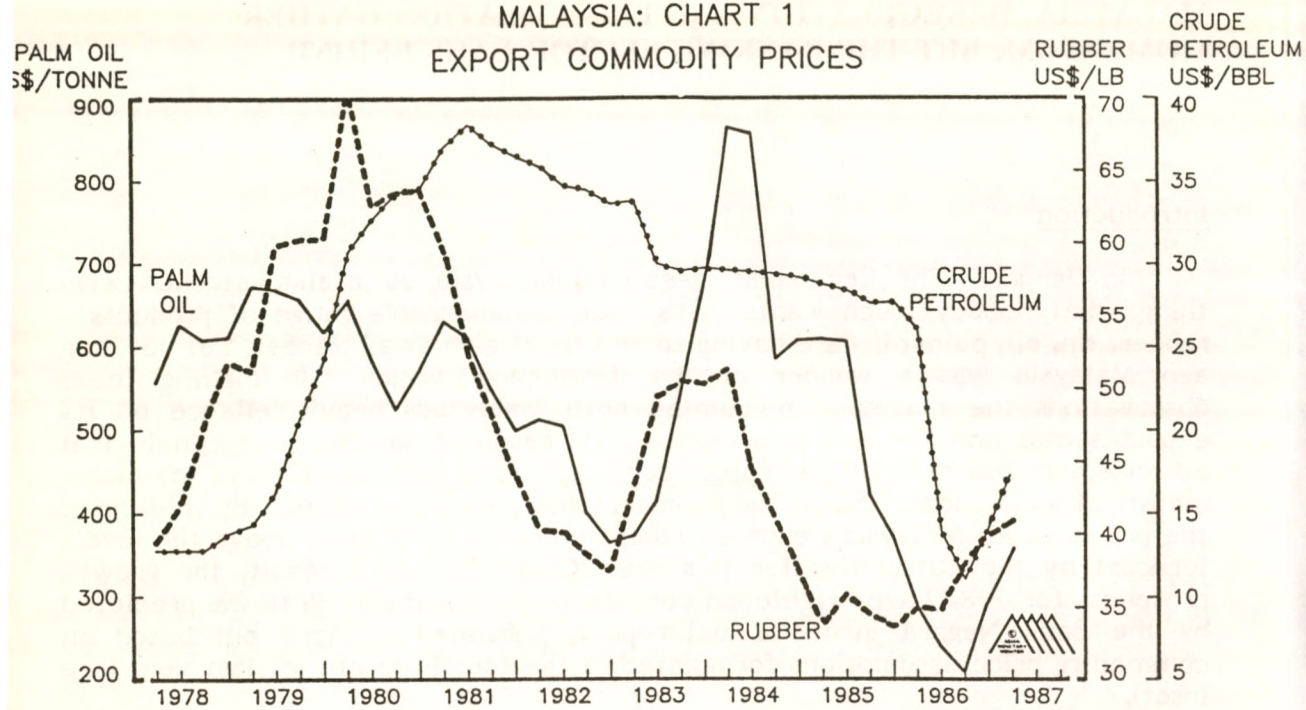
In January 'The Economist' described Malaysia as 'a shop stocked with things that nobody much wants. It's once incomparable range of products - rubber, tin, oil, palm oil - are having to be sold at give away prices. Yet not long ago Malaysia was a wonder of the developing world'. In making these observations the magazine pinpointed both Malaysia's heavy reliance on its export sector and the steady erosion of its resource wealth, as technological advancement has reduced per capita consumption of raw materials in the major industrialised nations. Since then some of the gloom has lifted. By mid-June, the prices of all Malaysia's exports except palm-oil were at or above the levels forecast by the authorities for this year (Chart 1). As a result, the growth prospects for 1987 have brightened considerably from the 1.5% to 2% predicted by the Bank Negara in its annual report, published in April but based on commodity price assumptions formulated in the fourth quarter of last year (see Inset).

The rise in commodity prices has had two impacts on the economy. It has resulted in a big real income gain as the terms of trade has improved and transformed the liquidity situation in the banking system from shortage to surplus, resulting in a sharp fall in interest rates. However, the propensity to consume and invest remains weak. In part this reflects the severity of the recession in 1985 (see Chart 2), when real GDP fell by 1% and 1986, when real GDP grew by 1% on early official calculations, but according to many estimates could have declined by anything up to 3%. This poor economic performance not only severely dented business and consumer confidence, but left industry with large amounts of spare capacity and propelled the unemployment rate to nearly 9%. More importantly, the severity of the recession also highlighted the adverse impact government involvement in the economy was having in inhibiting private sector economic activity.

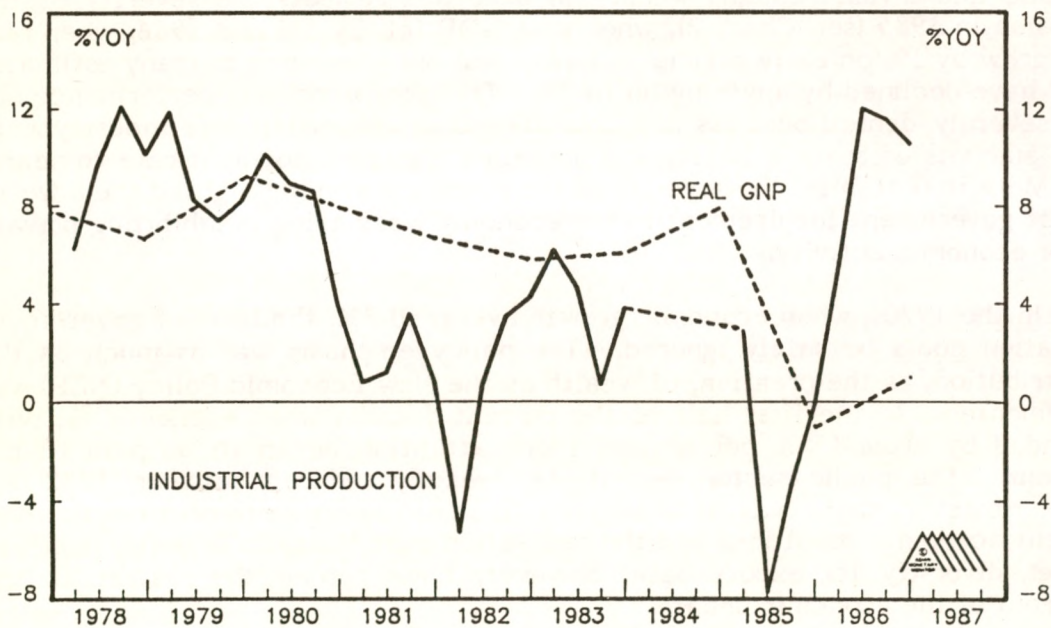
In the 1970s, when economic growth averaged 7%, the issue of government regulation could be safely ignored. The policy emphasis was as much on the redistribution, as the creation, of wealth as the New Economic Policy (NEP) was implemented. In the first half of the current decade, when economic activity expanded by around 5% per annum, more attention began to be paid to the problem. The public sector deficit was steadily reduced between 1982 and 1985. However, there was little urgency to streamline government regulations. Current economic conditions and the realisation that Malaysia urgently needs to further diversify its export base, however, have forced the matter to the forefront of the economic debate.

Several important steps have already been taken in deregulating the economy, as well as in streamlining existing government regulations. A programme of privatisation, less stringent exchange control regulations and the virtual exemption of small scale manufacturing industry from licensing

MALAYSIA: CHART 1
EXPORT COMMODITY PRICES



MALAYSIA: CHART 2
MALAYSIA'S ECONOMIC RECOVERY



1987 Forecasts of the Malaysian Economy

	Finance Ministry <u>Oct 1986</u>	Bank Negara <u>April 1987</u>	Probable* Out-turn based on commodity prices <u>Mid-June 1987</u>
<u>Assumptions</u>			
Crude petroleum	US\$13	US\$15.50	US\$18
Palm oil	M\$470	M\$850	M\$755
Rubber	M\$1.84	M\$2.10	M\$2.19
Tin	M\$16.5	M\$17.0	M\$16.8
<u>Forecasts</u>			
Manufactured exports M\$m	N/A	16940	17000
% change		12.0	12.4
Merchandise exports M\$m	34204	38400	41000
% change	-3.7	8.2	15.5
Merchandise imports M\$m	26909	28800	29000
% change	-0.7	6.3	7.0
Services account M\$m	-10232	-10070	-10500
Transfers M\$m	-130	-130	-130
Current account M\$m	-3067	-600	1370
Real GNP	-1%	1.5% to 2%	3%

- * Notes: (i) No allowance has been made for any material pickup in import volumes from the levels predicted by the Bank Negara, despite the higher growth forecast. This is because of the large amount of currently unutilised capacity.
- (ii) The oil price increase has resulted in a flurry of activity in the oil industry. Private sector contractors should especially benefit and this is expected to be one of the growth industries over the next 18 months.
- (iii) Allowance has been made for a slight drop in oil production.
- (iv) There is some evidence that demand for rubber is outstripping supply.

regulations are only three examples. But, in sharp contrast the financial markets have continued to be heavily regulated. In particular, the banking industry has continued to be used as one of the prime instruments in achieving the social objectives contained in the 'New Economic Policy' rather than as a channel for the efficient mobilisation and distribution of domestic savings.

This article is in two parts. The first half focuses on economic developments over the last 18 months. It highlights both how the limited flexibility of the exchange rate helped to cushion the Malaysian economy from the effects of global disinflation, but how an inflexible and overregulated banking system is now inhibiting the upswing. The second part contrasts this with the bold and imaginative steps which have been taken to remove government induced distortions in the manufacturing sector.

Monetary policy since 1985

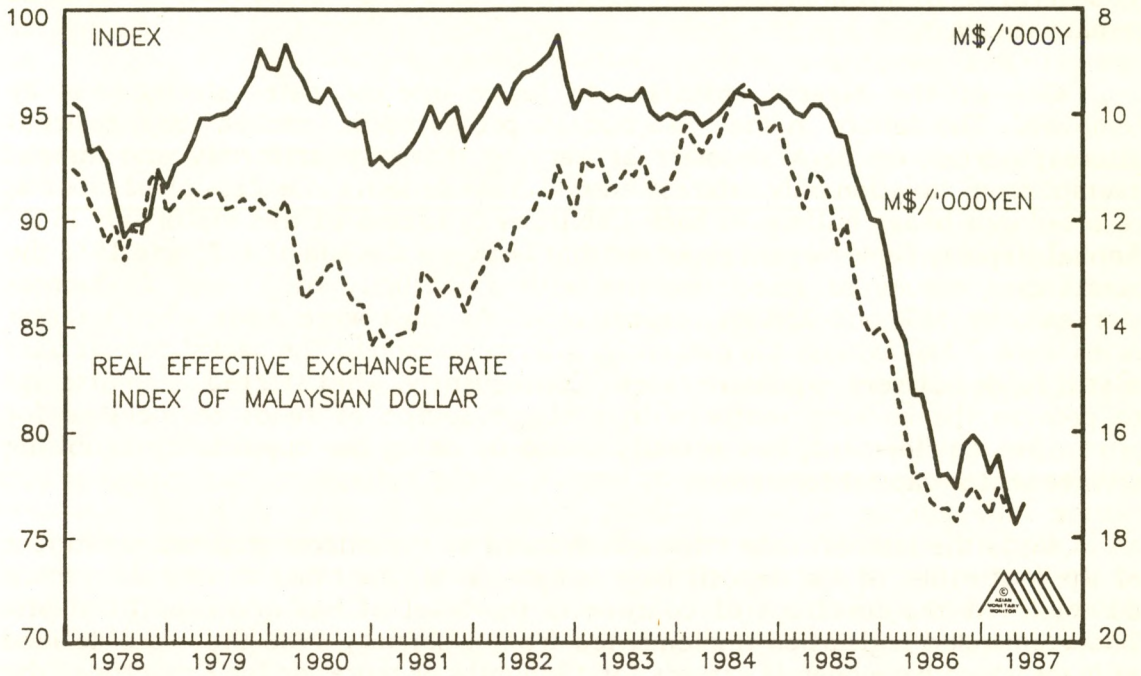
During 1986 the primary objective of monetary policy was to protect the exchange rate and to cushion the impact of the collapse in commodity prices during 1985 and the oil price in 1986. However, the extent of the deterioration in Malaysia's terms of trade meant that there was a general perception that the sharp drop in the real effective exchange rate (see Chart 3) was not sufficient to offset the drop in real incomes. Put another way individuals realised that there had been a permanent structural change in the terms of trade between Malaysia and the rest of the world. Had Malaysia maintained the fixed exchange rate regime that existed prior to June 1973, the effect would have been to exacerbate the downturn in the economy. As it was, the operation of the managed exchange rate regime allowed only a minimal cushioning of the downturn in economic activity.

As a result of speculation against the Ringgit, bank liquidity remained extremely tight during the first 10 months of last year. Bank deposits climbed by only 2.7% over the corresponding period of 1985 while loans grew by nearly 6.8%. A relaxation of the liquidity requirements of commercial banks from 20% to 18%, which released M\$2 billion into the system in February, and continuous central bank accommodation to the money market, was more than offset by support for the Ringgit in March and April and again in August. Government drawdowns of deposits held with the private banking sector also contributed to a drain on reserves.

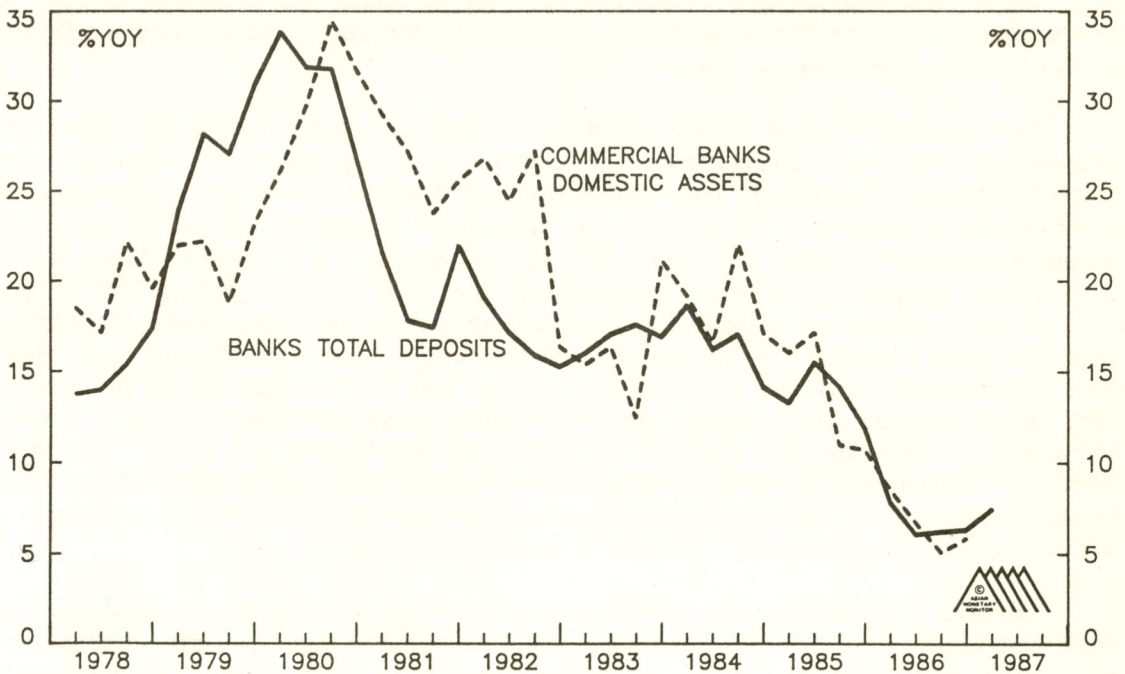
From October, however, the situation reversed sharply. A further reduction in reserve and bank liquidity requirements, from 4% to 3.5% and 18.5% to 17% respectively, combined with capital inflows to transform the deficit in the banking system to a large surplus. Interest rates began to fall, and in early February the banks were further aided by the central bank's decision to allow them to honour their liquidity requirements on an average basis, rather than adhering to a strict daily observation. By mid-June the banks' base lending rate had dropped in five stages to 7%, from its peak of 10.75% in 1986.

However, although interest rates are now at their lowest level for two decades, bank lending remains sluggish (see Chart 4). This reflects both a reluctance on the part of banks to lend as well as customers to borrow. Part of the reason is that interest rates, although low in nominal terms, remain high in

MALAYSIA: CHART 3
MALAYSIA'S GAIN IN COMPETITIVENESS



MALAYSIA: CHART 4
LOAN DEMAND REMAINS WEAK



real terms and relative to the perceived returns on capital available at this stage of the business cycle. Although rates should be lower, and the central bank has on several occasions indicated that bank margins are too large, rates continue to remain sticky.

One of the biggest obstacles to lower interest rates should soon be removed. The failure in the 1986 budget, presented in October 1985, to treat interest earned on bank deposits of varying maturity uniformly and instead exempt from taxation only interest earned from deposits in excess of 12 months, resulted in a heavy buildup in bank liabilities in excess of this maturity. In its Annual Report, Bank Negara reported that between the end of 1985 and 1986 the outstanding values of fixed deposits with a maturity of 15 and 24 months increased by 96% and 258.9% respectively. As most were made when interest rates were 7.5%, against 4% currently, a large portion of the banks' deposit base is still funded at very expensive rates. Consequently, what started as an attempt to provide the banking sector with a stable source of funds to mobilise for productive employment, has actually ended up doing the opposite by inhibiting private sector capital formation.

While the interest rate stickiness induced by the differential tax treatment of the maturities of the deposit base is ephemeral, the other causes seem more durable. At the forefront of concern is the level of bad and doubtful debts. Under amended legislation implemented from 1 January 1986 these are defined as loans which have been in arrears for 12 months or more, or for 6 months in the case of hire purchase agreements. Some estimates suggest that non-performing loans amount to between 20% and 25% of bank assets. The causes of the high level of bad debts are many. However, two would seem to dominate: firstly, the fact that the banks have in the past concentrated on the security offered rather than the soundness of the underlying business transaction; and secondly, the fact that under law banks are required to extend loans to priority sectors at concessional interest rates, when on normal commercial criteria they would not lend, or would lend only at 'loaded' rates.

The criticism that banks look too much at security rather than the underlying business transaction is particularly apposite in the current circumstances. The major form of collateral has been property - particularly commercial property. Because of over-capacity fuelled by the loan based property boom between 1980 and 1986, there has been a virtual collapse in the commercial property market. According to the Bank Negara, during 1986 nearly 46% of bank assets were lent to property companies or were property related. This occurred despite the central banks' warnings from as early as 1982 about over extension to any one sector. As a result the banks, which have been badly hurt financially by the downturn in the market, have become reluctant to lend. Though a valuable by-product of the current dilemma may be that it will force them to focus more on underlying business transactions, at present it seems as though a recovery in the commercial property market is almost a necessary, if not sufficient, condition for a recovery in bank lending.

Of still greater concern to the banking sector are the problems caused by enforced lending to 'priority sectors'. Current central bank guidelines stipulate: that 6% of the value of total loans outstanding as at December 1985 must go to food production; that banks must finance the purchase of a certain number of

low cost houses; that a certain portion of new loans must be made to small enterprises under the Special Loan Scheme, 50% of which must go to "Bumiputra" borrowers; as well as a general guideline that loans to the "Bumiputra" community must amount to 20% of total bank assets, also based on assets outstanding on 31st of December 1985. Altogether this means that about 20%-25% of new bank assets have to go to priority sectors, even after the general guidelines on lending to Bumiputras are excluded. The rate charged on these loans, 1.75% points over the base lending rate of the two largest commercial banks, which is currently 7%, compares with a base plus 4% points lending range to the non-priority sectors. Failure to comply with these guidelines results in a requirement to make a deposit with the central bank which earns only a token rate of interest, an option which in the current market many bankers are tempted to choose.

How to reduce the distortions in the banking sector poses a delicate and enormous task for the authorities. The New Economic Policy seems to be a political reality which will endure even after 1990. Priority lending, which is far from unique in South East Asia, would therefore seem set to remain a problem for the banks. But, as a second best solution, more effective competition between banking institutions is clearly necessary. The central bank has recently piloted legislation to place different financial institutions on an equal footing - an example being the steps taken last year to create uniform reserve requirements for commercial and merchant banks. There are also plans to create a secondary market in government debt, which at present is primarily taken up by the Employees' Provident Fund. Nevertheless, substantial scope for further deregulation and more forceful competition still exists. The two leading banks, Malayan Banking and Bank Bumiputra, which are also under heavy government influence, have an almost captive market for government business. Their base lending rate also provides the guideline for the lending rates of the other banks, who normally add about 0.75% points. The remaining banks are therefore able to use the two lead banks as a shield for their own inefficiencies.

One solution would be to structure the shareholdings of the two lead banks in a way that reduces government influence. Another would be to allow foreign banks greater penetration of the Malaysian market. However, against the background of last year's suspension of 24 deposit taking co-operatives and the rescue packages for two major banking institutions, the authorities are likely to proceed cautiously. They will need to carefully balance the need for a further tightening of their supervision of the banking system, which has already been strengthened since 1982, against regard for increased competition. Steps have already been taken to curtail the types of deposits co-operatives can offer. However, it is debatable as to whether a more deregulated banking system would not actually have prevented last year's debacle with the co-operatives from occurring.

Deregulation in the manufacturing sector

These continuing inefficiencies and regulations in the banking sector stand in marked contrast to the bold steps the authorities have taken in other areas, particularly in the manufacturing sector. The primary objective of deregulation in this sector is to speed up the diversification away from a reliance on commodity exports. In this, the authorities have met with some success.

Malaysia is now the world's third largest exporter of semi-conductors and last year the value of manufacturing exports, which accounted for 42% of total merchandise exports, grew by nearly 25%. Ten years earlier manufacturing exports accounted for just 19% of total exports. Steps taken to help the private manufacturing sector include, in the broadest sense, the reduction in the size of the public sector budget shortfall, thus releasing resources for private sector utilisation. From its peak of 17.5% of GNP, the deficit fell to a low of 8% of GNP in 1985, before rising to 18.3% last year as a result of a recession induced drop in government revenues. There is a commitment to eliminate the deficit on the operating account by 1990, as part of a proposal to limit the foreign debt service ratio to below 20%, as well as a general proposal to reduce and improve the quality of public sector investment. The chances of scarce resources being used for projects in which the country does not have a comparative advantage, such as the production of the Proton Saga, have therefore been reduced. Malaysia's international competitiveness has also been improved by last year's drop in the real effective exchange rate. A 'voluntary' three year wage freeze called for in this year's budget should, if successfully applied, maintain this advantage. In part this is a recognition that Malaysia's unit wage costs, which once provided one of the major attractions for foreign investment, are no longer low when compared to countries such as Thailand.

However, the overriding incentive for an improvement in investment prospects has been provided by the streamlining of government regulations and the virtual exemption of small manufacturing units from licensing requirements. The level of exemption from the licensing requirement for manufacturing activities was raised from M\$1 m to M\$2.5 m of own capital last year. In instances where a licence is required, there has also been a drive to reduce the waiting time, which in the past has been as long as two years. Reinforcing this were the provisions contained in the Promotion of Investment Act 1986, which replaced those included in the Investment Incentives Act. The new act provides for a more generous interpretation of industries qualifying for the five year 'tax holiday', as well as holding out the prospect of a time extension in special circumstances. There were also signs that the original objectives of the proposals to redistribute wealth as contained in the New Economic Policy, which limited foreign ownership of enterprises to 30% by 1990, would be waived under certain conditions. In short, this means that a foreign investment made between 1 October 1986 and 31 December 1990 could, on meeting certain specified criteria, be exempted from the regulations - eliminating any need for a restructuring of shareholdings in 1990.

Reinforcing the steps towards the more efficient use of resources is the continued commitment to privatisation. Up to now this has been largely confined to the transportation sector, Malaysian Airline Services and Malaysian International Shipping Corporation being the prime, as well as conspicuously successful, examples. However, there are also plans to sell off the telecommunication industry and further sales of government owned utilities cannot be ruled out. It was the Prime Minister, Dr. Mahathir Mohamad, who described Malaysia's own (though not unique) experiences with public utilities in a speech to a seminar on privatisation on 13 October 1984 '.... public enterprises never seem to be profitable or efficient. Even when they are monopolies they cannot seem to earn their way, much less pay tax or dividends to their owner - the government. More often than not, a privately owned enterprise which has

been making profits and paying taxes, not only ceases to do both on nationalisation, but requires injections of capital every now and then by the government.' He then went on to describe the consequences for Malaysia of failing to reverse the growing role of the public sector: 'The alternative to privatisation may be to stop improving or providing the needed facilities. This will result in increasingly poor revenues and will stifle growth. Development will be retarded and the second prong of the NEP, eradication of poverty, will not be accomplished'.

FORECAST: The drop in commodity prices during 1985 and 1986 has brought to the fore Malaysia's need to use its resources effectively and efficiently. The authorities attitude towards privatisation highlights their belief that the most effective way of achieving this is via the market mechanism. The political realities will ensure that the New Economic Policy remains a force even after 1990. The conflict between the creation and distribution of wealth will therefore continue. However, as government regulations are streamlined and privatisation proceeds, the focus of the economic policy objectives will swing slowly away from the distribution, towards the creation, of wealth. How far the bias goes will depend on the political will to implement what is economically necessary, but at times will not seem politically expedient.

Ultimately commodity prices will continue to dictate Malaysia's economic performance. Building a significant domestic market will be a long and arduous process. But, freeing the economy from many of the shackles of government interference will make it more resilient to any sudden drop in commodity prices. Based on commodity prices ruling in June, a 4% average growth rate over the next 5 years would seem sustainable. This is well below the 5.0% predicted in the five year plan and poor by historical standards. It is also probably not sufficient to contain unemployment, which will test the government's resolve to become more involved in the economy. Nevertheless, if the current policy stance is persevered with, it may well lay the ground work for much faster growth during the 1990s.

THAILAND: AFTER A CHANGE IN MONETARY POLICY, A SHIFT IN FISCAL POLICY

Introduction

1986 marked an important turning point in Thailand's economic fortunes. Firstly, the economy appeared to reach the lower turning point in the business cycle late in the year. This followed two consecutive years during which average economic growth, at 3.8%, was only slightly more than half the historical norm. Secondly, the current account of the balance of payments, which had been improving steadily since 1984, swung into surplus for the first time since 1966 (see Chart 1). In addition to the terms of trade gain resulting from the drop in the oil price, this also reflected buoyant earnings from tourism and rapid growth in export volumes, as a continued diversification away from a reliance on agriculture enabled Thailand to capitalise on the increased competitiveness resulting from the fall in the real effective exchange rate. Thirdly, interest rates which have typically been very high in both real and nominal terms fell to their lowest levels in nominal terms for a decade. The prime lending rate was reduced in five stages, from 16.5% to 12%, and by a further 0.5% in early 1987, while the rate on 1-2 year time deposits dropped from 11% to 7.25%.

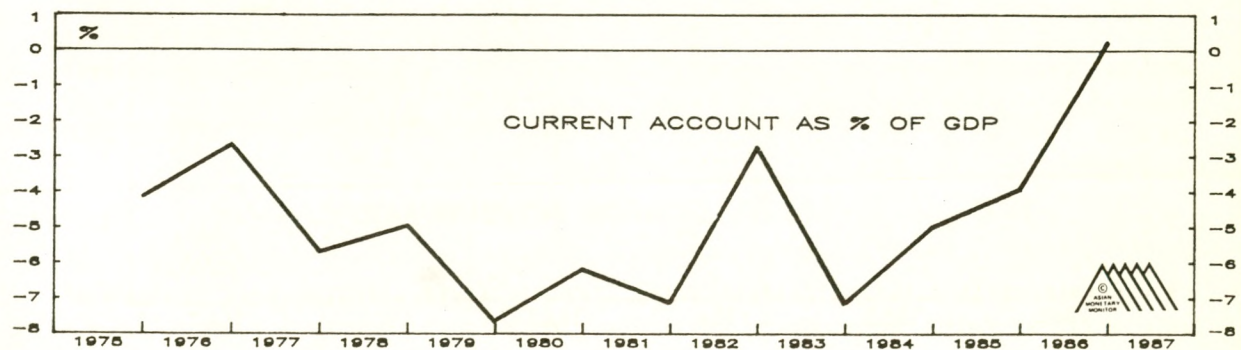
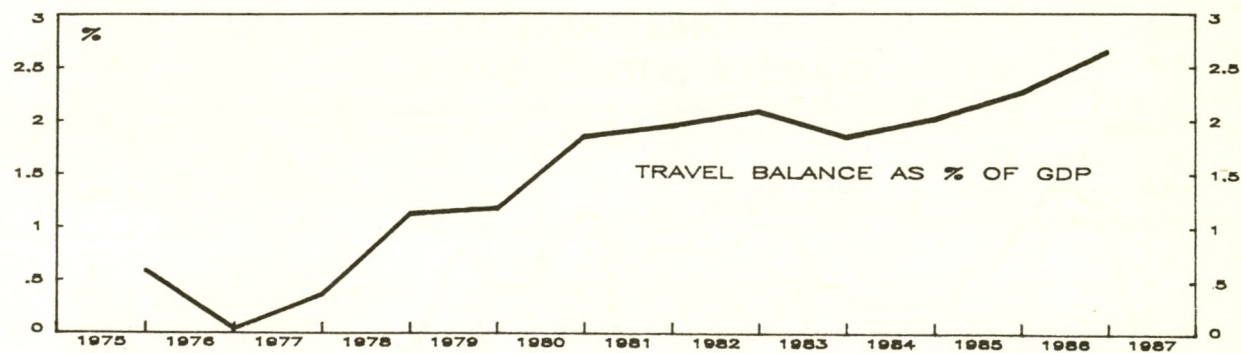
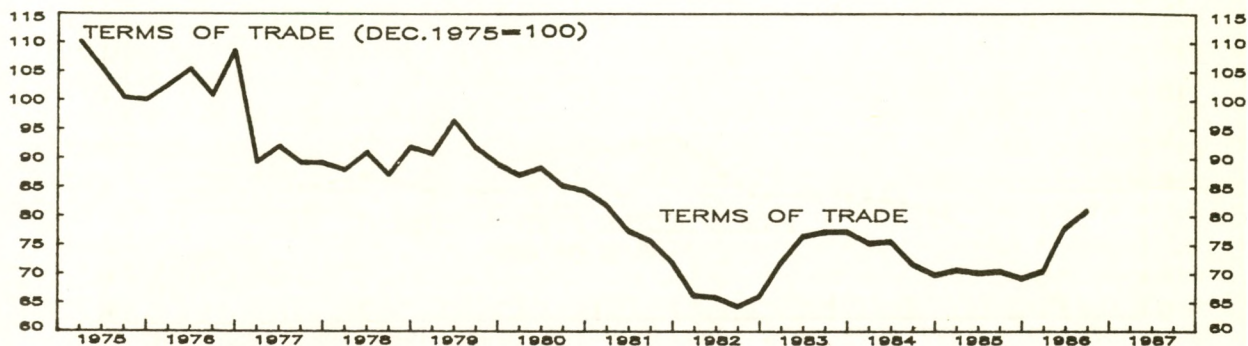
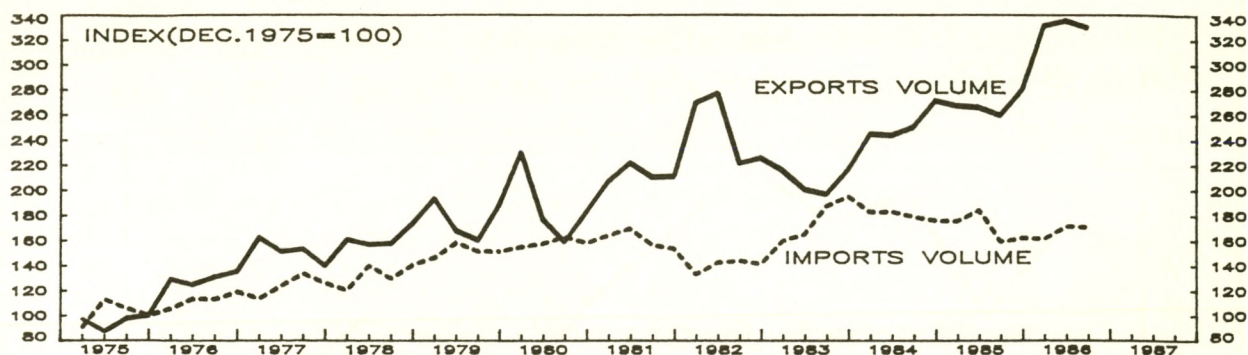
Early indications suggest that the recovery is likely to be vigorous. During the first quarter of 1987 direct foreign investment was double that of the corresponding period a year earlier, exports were up by over 10%, while tourist receipts are estimated to have climbed by over 20%. Last year's drop in interest rates has also paved the way for these developments to feed through into stronger domestic demand. The construction industry, an important leading indicator of the business cycle, picked up strongly during the first quarter, and although the agricultural sector is likely to remain subdued in the wake of last year's crop failures, there are signs that demand for durable and semi-durable consumer goods is beginning to revive even in rural areas.

The durability of the upswing will hinge on two factors: the ability of the authorities to conduct monetary policy in a way that reduces monetary instability; and the success of government in limiting its role in the economy. In the past Thailand has experienced considerable monetary instability because of the rigidity of the interest rate structure, while increasing government involvement in the economy has diverted resources away from the private sector and contributed to high domestic interest rates. In both instances the net result was to inhibit private sector capital formation (see Chart 2). However, last year's developments suggest that the Thai authorities have gone some way towards reversing the way in which both monetary and fiscal policy are conducted.

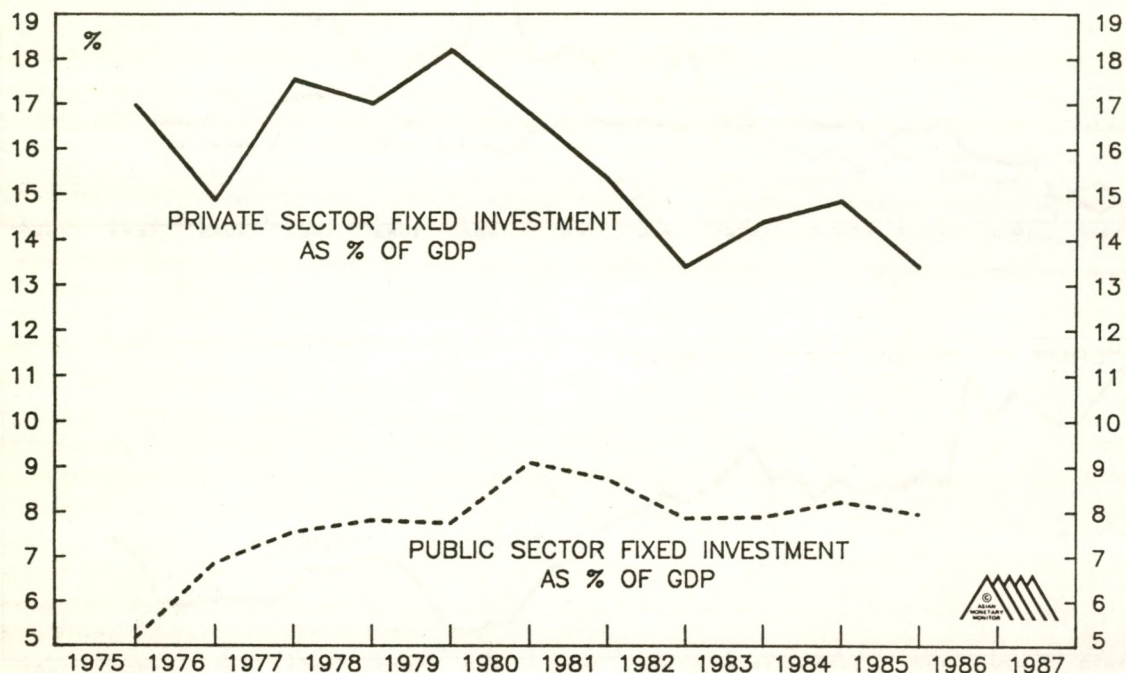
Interest rate inflexibility

The drop in interest rates marked a sharp break with the past pattern of rigid interest rates (see Chart 3). The rigidity of the interest rate structure came about primarily because of the tendency of the banking system to borrow

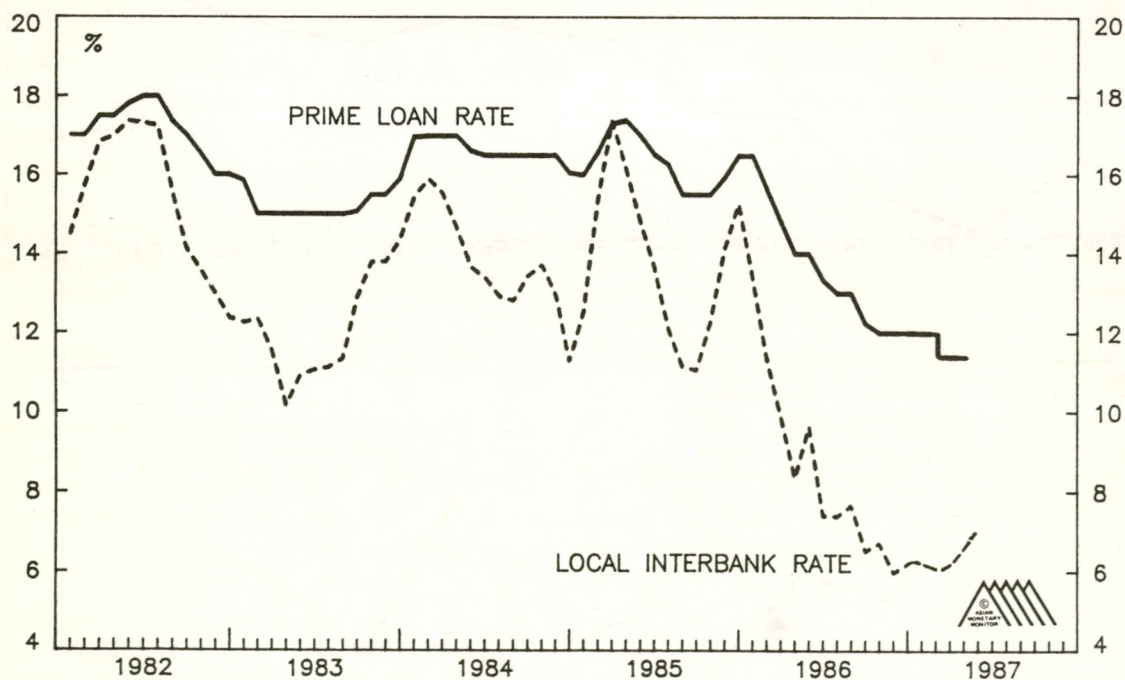
THAILAND: CHART 1
DEVELOPMENTS ON THE CURRENT ACCOUNT



THAILAND: CHART 2
PRIVATE AND PUBLIC SECTOR FIXED INVESTMENT AS % OF GDP



THAILAND: CHART 3
DOMESTIC INTEREST RATES



long and lend short. Since 1980 time deposits (effectively fixed interest rate deposits) on average accounted for between 70% and 75% of total private sector liabilities of the commercial banks, while turnover averaged less than 1% (see Chart 4). This made banks reluctant to alter interest rates in response to changed market conditions. At the same time the heavy demands made by the public sector on a diminishing savings pool resulted in a heavy reliance on foreign capital, obtained by the private sector, to finance the current account shortfalls.

In the face of Thailand's rigid interest rate structure the decision by private sector borrowers as to whether to finance their needs domestically or offshore was a function of movements in US interest rates. Because this decision was made independently of the financing needs brought about by cyclical developments on Thailand's current account, considerable monetary instability resulted. Over the seven years between 1980 and 1986 the annual increases in M1 were 13.8%, 3.3%, 8.1%, 4.7%, 11.5%, -3.5% and 18.6%. The Thai-US interest rate differential became a causal factor in determining the overall balance of payments, rather than a consequence of balance of payments developments as would normally be the case in a fixed exchange rate regime (see AMM Vol. 10 No. 1).

However, while interest rates clearly became more flexible last year, current institutional arrangements, whereby banks rely heavily on fixed interest time deposits, means that the lag time between changes in monetary conditions and interest rate responses is likely to remain long. Chart 3 shows that the prime rate still remains high relative to money market rates, despite the steep decline over the last 15 months. The gap between the prime and interbank rates has widened substantially, notwithstanding the Bank of Thailand's exercising of moral suasion on the commercial banks to narrow the gap. The current differential between the prime lending and interbank rates is nearly 400 basis points, instead of the 200 basis points which has on average existed historically.

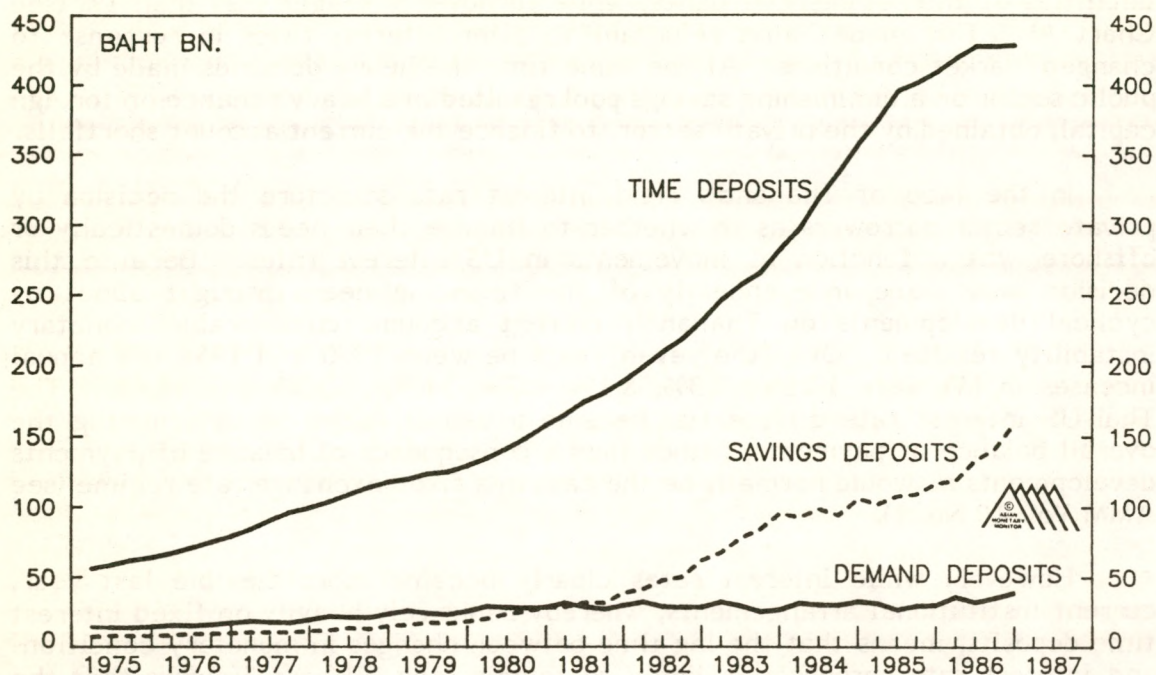
The development of a more active money market means that 'blue chip' companies currently have the option of using the money market, where they would pay approximately 6.5%-7% for 3 month money, but for smaller companies even the cost of borrowing at prime (which in practice they are not able to do) would act as a disincentive to investment. At prime plus 2% points the real cost to this type of borrower would be approximately 11.5%, using the consumer price index as a deflator. Using the wholesale price index - which shows that prices have been declining over the year - the real cost of borrowing would be 13.5%.

In the short-term therefore, any tightening of liquidity is first likely to feed through into higher money market rates. Large corporations are likely to make increasing use of the money market rather than borrowing at prime, and there are also already signs that the authorities propose to overfund by accelerating the issue of short-term government bonds in an attempt to mop up the excess liquidity. How the interest rate pattern develops thereafter is likely to depend on the financing demands of the public sector.

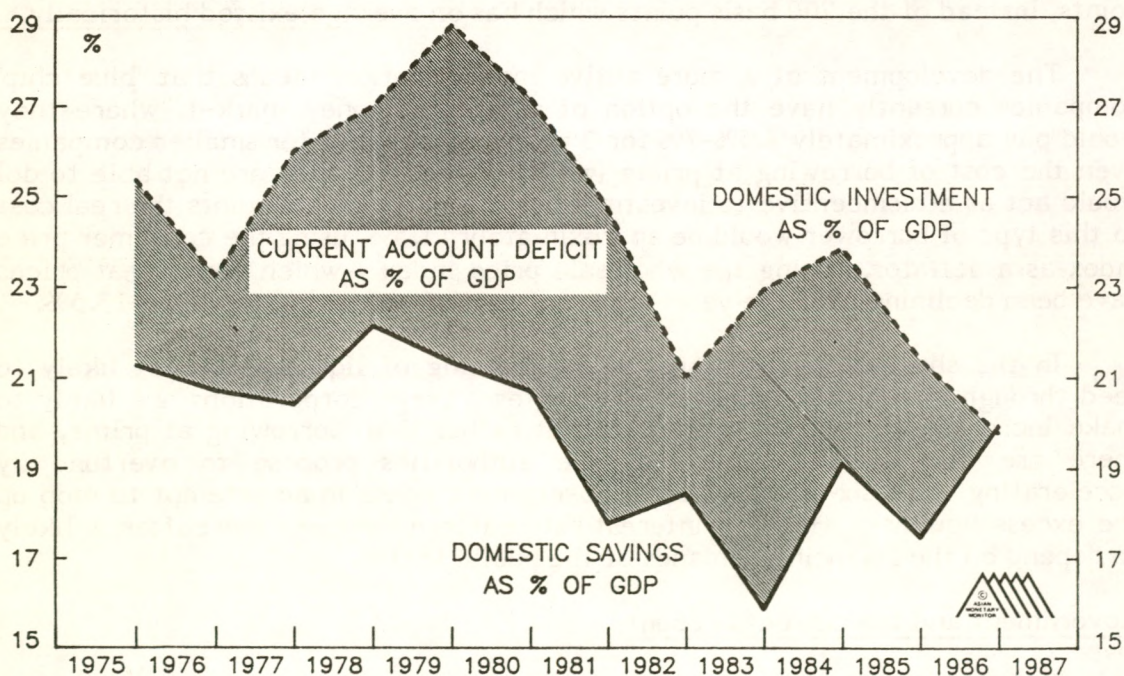
Government and the current account

In fiscal policy as in monetary policy there are signs that the authorities have embarked on a long range policy which if adhered to would mark a sharp

THAILAND: CHART 4
COMMERCIAL BANKS DOMESTIC LIABILITIES TO PRIVATE SECTOR



THAILAND: CHART 5
DOMESTIC SAVINGS AND INVESTMENT AS % OF GDP



break with past practice. The Sixth Five Year plan, covering the period 1987-91, places the emphasis on the private sector as the driving force of the economy. To this end the growth in real public sector fixed investment is to be contained to an average annual increase of less than 1% per annum, compared with 2.4% in the previous five years, while private investment is projected to expand by 8% per annum. The importance of reducing the role of the public sector in the economy is illustrated by developments over the last 10 years, when big public sector deficits resulted in equivalently large current account shortfalls, crowded private sector borrowers out of the domestic market, and resulted in a considerable build-up in the country's external indebtedness. Last year Thailand's external debt reached an estimated US\$16 billion - equivalent to 30% of GDP.

Table 1 uses a cross sectional approach to highlight the extent to which the current account shortfalls and the concomitant rise in foreign debt has become a policy problem in Thailand. On a per capita income basis, Thailand is classified by the World Bank as a 'lower-middle income' country. The comparison with other countries at a similar stage of economic development shows that Thailand's current account deficits, although large in absolute terms, were smaller even before the improvement in recent years. Between 1979 and 1984 the average annual current account shortfall in Thailand expressed as a percentage of national income averaged 6.6%, about one percentage point lower than the average of the 18 other countries in the same classification, while both its domestic savings and investment ratios were substantially higher. However, this favourable comparison has been more of a reflection of the economic mismanagement that occurred in other countries, than a tribute to the dexterity with which Thai economic policy has been conducted. It disguises the fact that in the face of a falling domestic savings ratio, the deficit was only continued at the expense of the slow growth in private sector capital formation (see Chart 2).

TABLE 1
CURRENT ACCOUNT POSITIONS AS % NATIONAL INCOME
IN 'LOWER-MIDDLE INCOME' COUNTRIES
1979-84

	Thailand	Other lower-middle income countries
1. Domestic investment ratio	24.9	20.7
2. National savings ratio	24.9	20.7
3. Current account shortfall = (Foreign savings)	-6.6	-7.8
4. Domestic savings ratio = (1-3)	18.3	12.9
5. Dependence on foreign capital = $(3 \div 1)$	26.5	37.7

Chart 5 shows that the ratio of total domestic savings to income fell from over 21% in the mid 1970s, to a low of slightly less than 16% in 1983. Although it subsequently recovered and reached 20% last year, this represented a cyclical low in domestic expenditure. The decline in investment as a fraction of total

income was even more pronounced. After rising from 25% in 1975 to nearly 29% in 1979, the ratio fell to a low of less than 20% last year. Consequently, had Thailand continued to follow the pattern experienced between 1975 and 1979 - trends which have been common to most countries on the Pacific Rim since 1980 - the current account shortfalls would have been as big as other countries in the group.

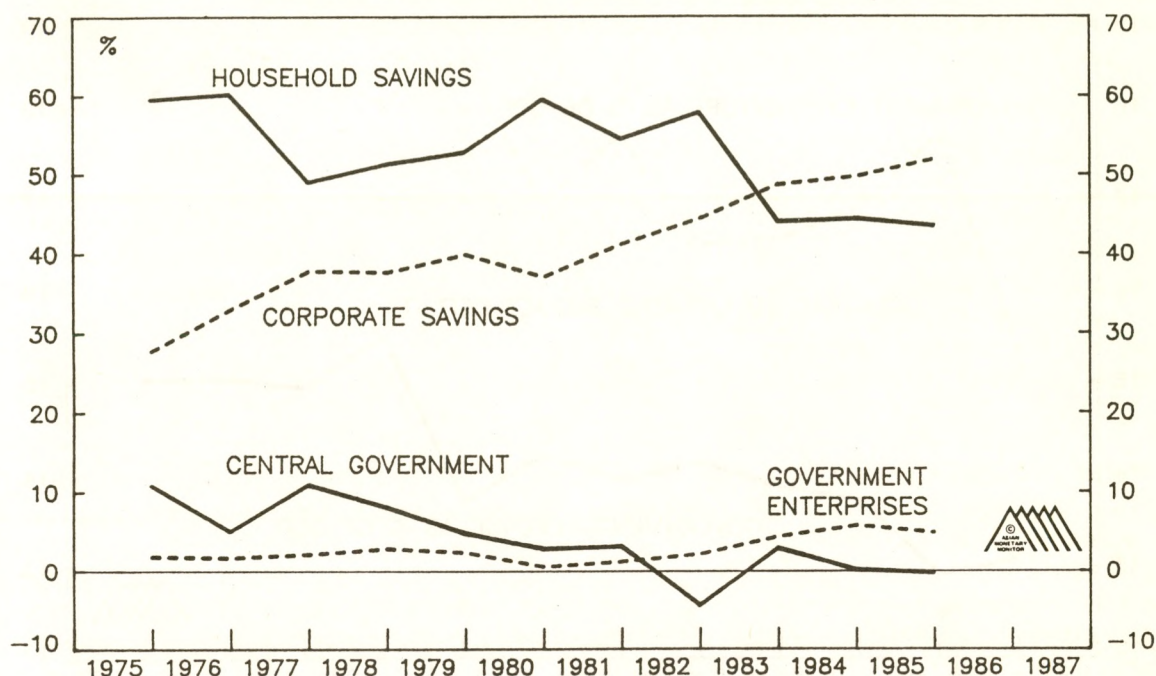
Charts 6 and 7 show that the primary statistical cause of the current account deficits was the increasing share of private sector savings which were used by the public sector (defined as central government and the public enterprises). This had two elements: the decline in public sector savings, mainly as a result of a decline in central government savings shown by Chart 6, to the extent that government actually disaved in 1983; and the increase in public sector investment owing to infrastructural projects. This is highlighted by the growing deficit in the public sector (excluding inventories) in Chart 7.

The new five year plan contains a number of proposals to reverse this trend. These include: scaling down the size of public sector investments; ensuring that 25% of any new public sector investment is financed from internal sources; privatisation and encouragement of private sector involvement in infrastructural projects. If adhered to, Thailand would be well placed to achieve an acceleration of private sector investment without a material deterioration in the current account, a substantial increase in the requirement for foreign capital or a rise in interest rates.

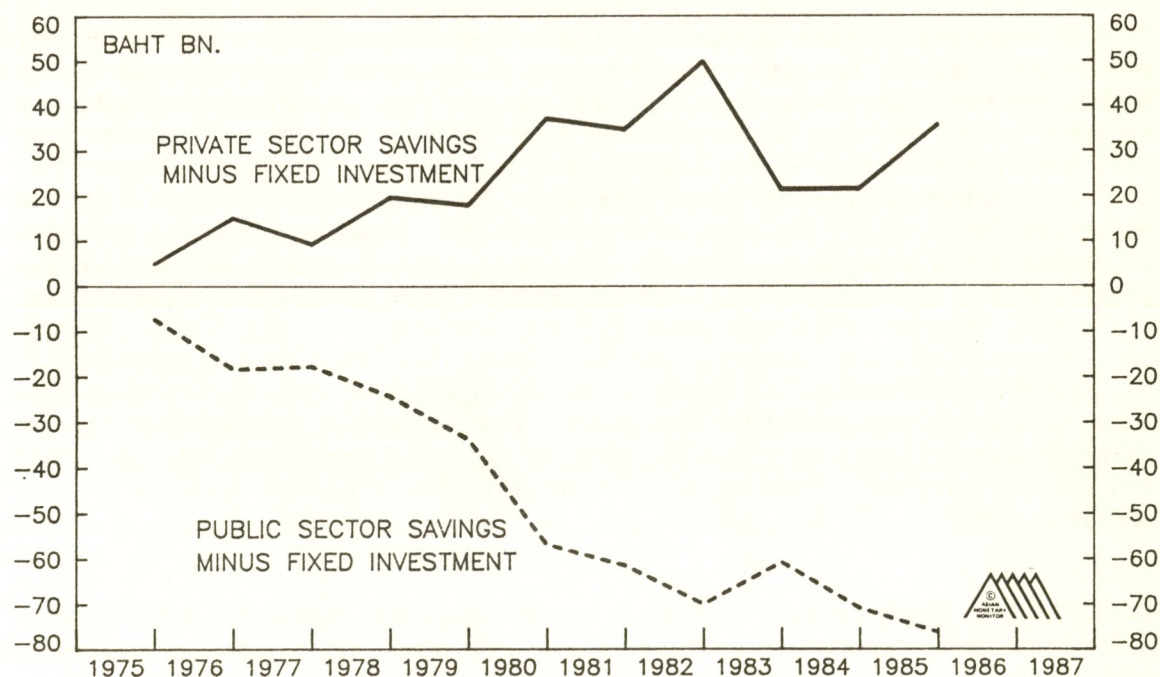
Two factors in particular point to this conclusion, namely the interaction of the growth in corporate savings, shown on Chart 6, and the difference in the composition of public and private sector fixed investment. While public sector investment is mainly orientated towards heavy industrial projects, private investment is concentrated mainly in light manufactured goods. The growth in savings by corporations has been largely a consequence of the continued diversification of the Thai economy away from agriculture in response to the steady deterioration in the terms of trade resulting from falling commodity prices. In 1975 the agricultural sector contributed about 30.4% to GDP, but by 1980 the ratio had dropped to 22.4%. Over the same period the share added to GDP by manufacturing rose from 17.7% to 21.0%. The ambitious plan by the authorities to provide the scope for private sector investment to expand by 8% per annum implies a continuation of this diversification and a further build-up in corporate savings. Investment in light manufactured machinery should therefore be financed to a considerable extent from internal sources.

However, while there are plans to curtail public sector investment, the absence of a firm commitment to reduce current spending is conspicuous by its absence. Chart 8 shows the steady rise in government expenditure since 1975 and the corresponding climb in government revenues which was necessitated to minimise the size of the budget shortfall. Unfortunately the gap between expenditures and revenues is only a partial estimate of the budget deficit as it excludes off-budget items for which no breakdown of expenditures and revenue exists. When the off-balance sheet items are included, the deficit is shown to have declined from a peak of 5.1% of GDP in 1985 to 4.5% last year, primarily as a result of the containment of 'measured' government spending to within 18% to 19% of GDP. Not coincidentally this was also the period during which the

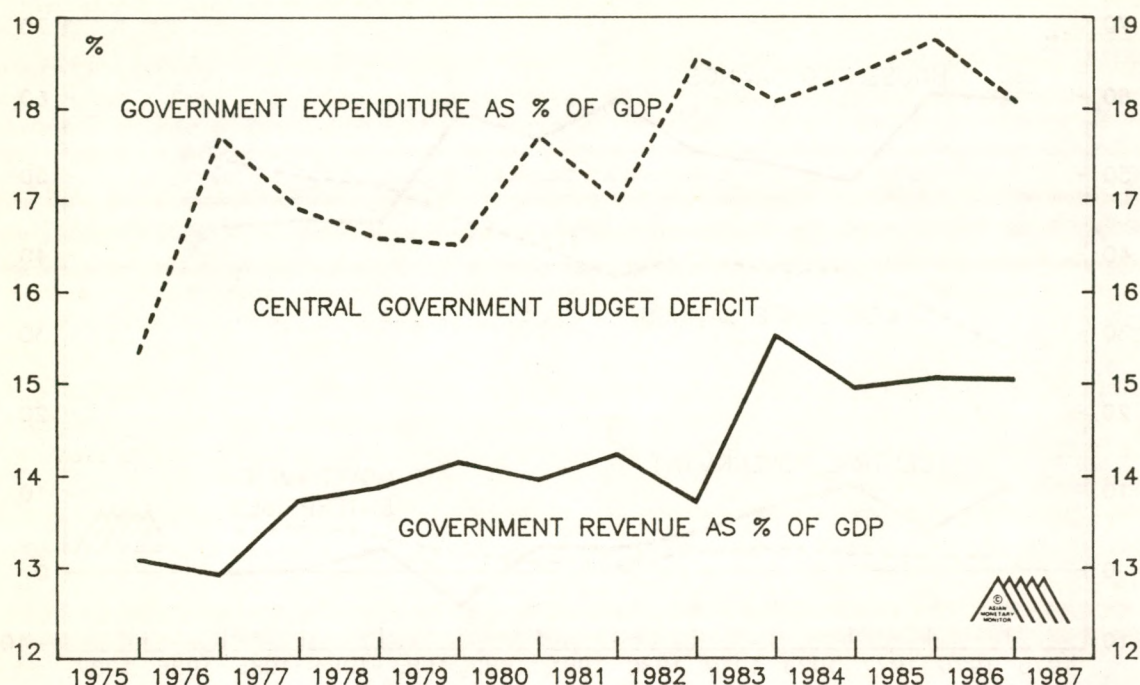
THAILAND: CHART 6
CONTRIBUTION TO DOMESTIC SAVINGS



THAILAND: CHART 7
SAVINGS MINUS FIXED INVESTMENT



THAILAND: CHART 8
CENTRAL GOVERNMENT BUDGET DEFICIT AS % OF GDP



current account shortfall narrowed sharply. However, this containment, as in the 1970s, was only achieved via a contraction in capital expenditures. Current expenditures continued to rise steadily as they had done since 1975.

The second element in the Thai authorities' efforts to contain the size of the budget deficit has been the attempt to improve Thailand's notoriously inefficient tax collection system. To this end the Thai authorities enacted a tax amnesty period in 1986, while the incentive towards greater tax honesty was provided by a reduction in the top marginal income tax rate from 65% to 55%, and a reduction in the corporate tax rate for companies not listed on the Securities Exchange of Thailand, from 40% to 35%. However, boosting revenues by reducing tax avoidance might do little more than transfer savings from the private sector, unless there was a corresponding fall in government expenditures.

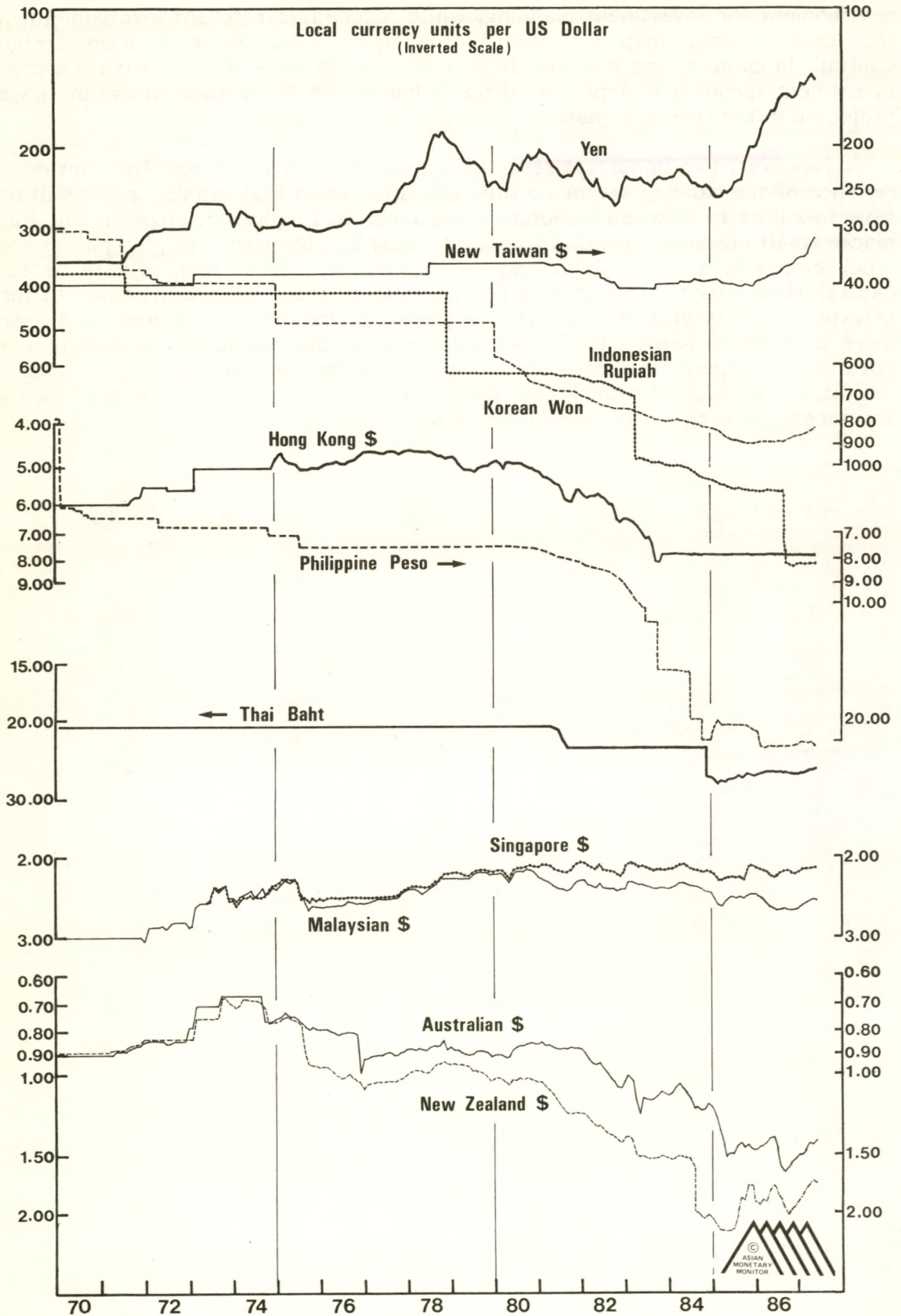
Based on the estimates for the Sixth Five Year plan, for the period 1987-91, government revenues are expected to average 15.3% of GDP, marginally up from 14.6% for the previous five years. If government expenditures remain static at current levels of 18%-19%, other things being equal, this will mean that the central government sector will continue to exert a large drain on private sector savings.

FORECAST: The buoyancy of the economic indicators during the first quarter point to a vigorous recovery in the economy this year. The important structural changes made in respect of monetary policy and the government's role in the economy also point to the recovery lasting for some considerable time, if they

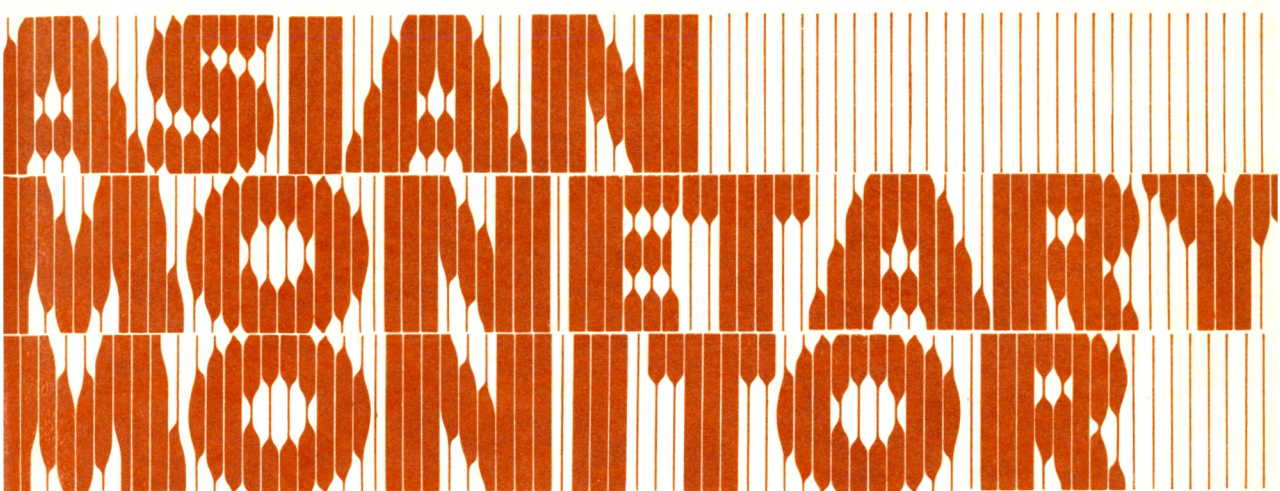
are capitalised on. Increased monetary stability should provide a more conducive environment for investment planning, while reduced government involvement in the economy should help to contain borrowing costs and the reliance on foreign capital. In combination they should provide a sound basis for real private sector investment spending to approach, if not achieve, the 8% average annual increase projected in the five year plan.

However, two important reservations also need to be made. The continued reliance of the banking sector on time deposits means that interest rates will be slow to adjust to changed monetary conditions. In the current environment this places small investors at a disadvantage. Secondly, the five year plan places too much emphasis on government capital expenditure rather than private sector capital expenditure. Transferring resources away from the public sector to the private sector is vital as competitive pressures ensure the resources are used more efficiently, raising the growth potential of the economy. Rising current government expenditure does the reverse, and in contributing to the budget deficit, keeps interest rates higher than they otherwise would have been, slowing the pace of private sector capital formation.

EXCHANGE RATES IN THE FAR EAST







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REGIONAL SURVEY: CURRENCY MOVEMENTS ARE ALTERING THE FOCAL POINTS OF REGIONAL ECONOMIC GROWTH

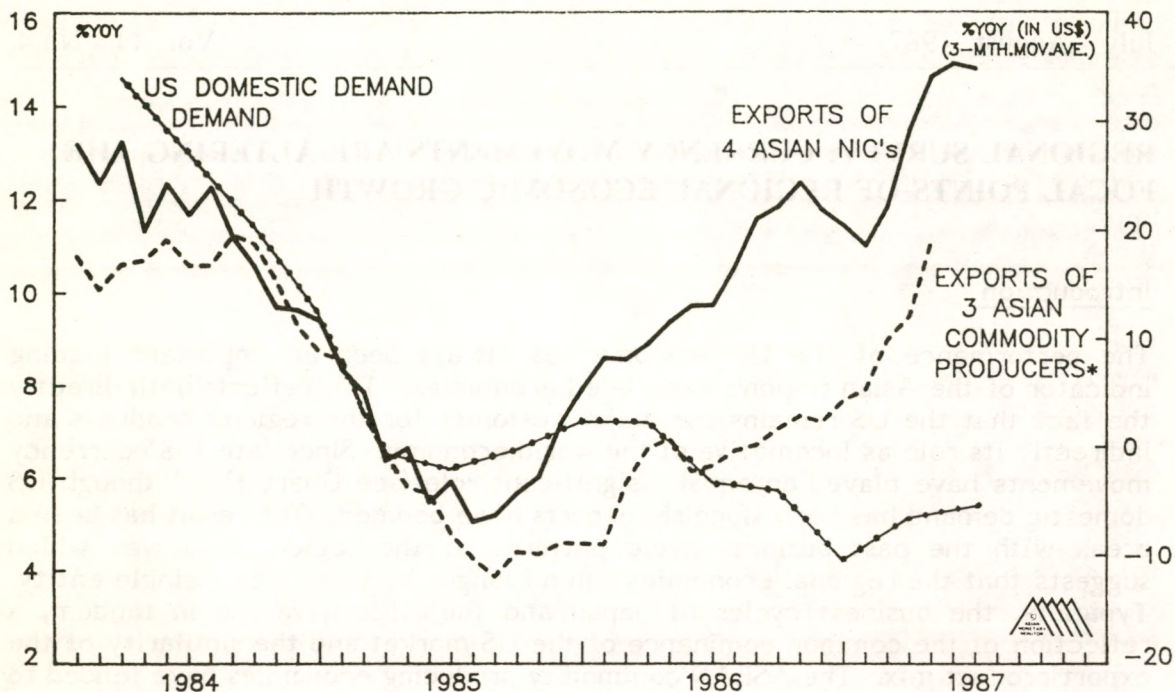
Introduction

The performance of the US economy has always been an important leading indicator of the Asian region's export-led economies. This reflects both directly the fact that the US remains the major customer for the region's products and indirectly its role as locomotive of the world economy. Since late 1985 currency movements have played an equally significant role (see Chart 1). Although US domestic demand has been sluggish, exports have boomed. The result has been a break with the past business cycle patterns of the region, in a way which suggests that the regional economies can no longer be viewed as a single entity. Typically, the business cycles of Japan and the NICs have run in tandem, a reflection of the common dominance of the US market and the similarity of the export product mix. The ASEAN commodity producing economies have tended to lag until the later stages of the recovery in the major industrialised nations, when the investment cycle gathers momentum.

In the current business cycle the recovery in the Thai, Malaysian and Philippine economies during the second and third quarters of 1986, a full year after the NICs, conforms with this pattern. But the performance of the Japanese economy and of the economies of the NICs has shown a marked divergence. As the yen began to appreciate more rapidly against a weakening US dollar than either the Taiwanese dollar or the Korean won, and with the Hong Kong dollar link remaining intact, the focal point of economic growth within the region swung away from Japan towards the NICs. Last year Japanese real GNP grew by just 2.4% compared with a 3.9% average rate of climb during the previous five years. This represented the worst growth performance since 1975. In contrast the Hong Kong, South Korean and Taiwanese economies grew by 11.2%, 12.6% and 10.8% respectively. In the first six months of this year the South Korean economy expanded by a further 15.3%.

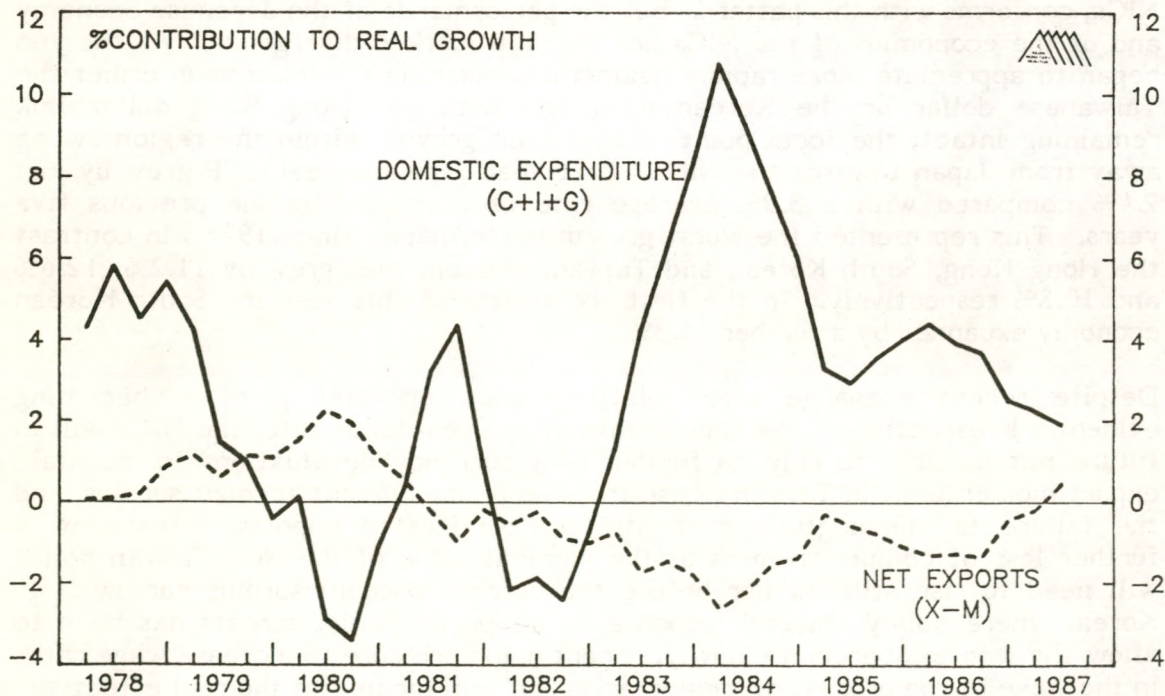
Despite recent exchange rate volatility one important point is becoming evident. Irrespective of the movements in the yen-dollar rate, the NICs will in future not be able to rely on further real currency devaluations to maintain export momentum. In Taiwan's case the size of the current account surplus, and the failure to meaningfully dismantle the barriers to imports, foreshadow a further loss of competitiveness as the nominal value of the New Taiwan dollar will need to rise still further before the current account surplus narrows. In Korea, where policy makers' response to US protectionist threats has been to allow the won to appreciate slowly, recent union pressure to increase wage rates in the wake of the process of 'democratisation' will mean that the real effective

CHART 1
US DOMESTIC DEMAND AND ASIAN EXPORT GROWTH



*MALAYSIA, THE PHILIPPINES AND THAILAND.

CHART 2
DOMESTIC DEMAND HAS FUELLED US ECONOMIC GROWTH



value of the won will rise, irrespective of nominal currency movements.

In the long-run economic planning, as well as the rational response to market forces, will cause a shift in resources within the NICs towards the production of higher value added goods for which demand is less price elastic. Already for example there is evidence that South Korean corporations are devoting a larger proportion of budgets to research and development. However, in the short-term price competitiveness will play a crucial role. With US monetary policy tighter much will depend upon whether Taiwan and Korea are able to exploit competitive gains in Europe and Japan and whether Hong Kong maintains the improvement in market share achieved during 1986. The growth performance in these major industrialised countries as well as in the US will therefore become crucial.

In attempting to analyse the likely distribution of economic growth within the region over the next eighteen months, this article sets out to answer three questions:

- (a) Do recent currency movements and the economic outlook for the major industrialised countries signal the end to the export boom for the NICs?
- (b) If the export boom has run its course, have the domestic economies of Taiwan and Korea been deregulated sufficiently, and is either monetary or fiscal policy likely to prove expansionary enough throughout the NICs, to allow domestic demand to maintain the growth momentum in these countries?
- (c) Will recent recoveries in the ASEAN countries be sufficient to allow economic growth to converge with that of the rest of the region?

The outlook for exports

The importance of currency movements to the NICs is highlighted by last year's bilateral trade with the US. While US real domestic demand growth remained unchanged from the previous year at around 3.5%, the volume of imported manufactures rose by 10.3%. This represented a slight slowdown from the 12.1% climb in the previous year. However, currency movements enabled the NICs to capture market share at the expense of Japan. Overall in volume terms Taiwan's exports grew by 25.0%, the highest rate of climb since 1976, while South Korean export volumes were up by 13.3%. Among the city states, Hong Kong's domestic export volumes gained 15.3% and Singapore's 13.4%. In contrast Japan's export volumes dropped by 0.6%.

This year export volume growth is likely to slow for two reasons. The first is because of a partial reversal of currency movements, the country most affected being Taiwan. The New Taiwan dollar has begun to appreciate at an accelerated rate against the US dollar, gaining 17.6% during the first eight months of this year against 12.7% during the whole of 1986. With the Japanese yen having strengthened less against the US unit, Taiwan's export competitiveness, which as Chart 3 shows had already deteriorated significantly since early 1986, has been further eroded. By June the real effective exchange rate had returned to early 1982 levels, well above the average for the last decade, and up by 18.8% from

NICs & JAPAN: Gains and losses in export competitiveness
to major customers in the current business cycle
at 30 June 1987

(- % loss + % gain)

	<u>December 1982*</u>	<u>since</u> <u>March 1985**</u>	<u>January 1986***</u>
<u>Japan to:</u>			
US	-24.4	-31.9	-15.8
Japan	-	-	-
UK	-7.5	-2.4	-2.8
Germany	-3.3	-9.3	-5.6
<u>Taiwan to:</u>			
US	-14.0	-14.6	-19.2
Japan	+13.2	+24.8	-0.9
UK	+5.2	+22.3	+2.4
Germany	+9.9	+37.0	+5.1
<u>S. Korea to:</u>			
US	+10.9	-4.5	-7.4
Japan	+46.7	+40.3	+10.0
UK	+35.7	+36.8	+13.0
Germany	+41.8	+53.3	+16.1
<u>Hong Kong to:</u>			
US	+6.3	-4.2	-5.7
Japan	+58.1	+56.5	+20.7
UK	+12.1	+27.4	+10.5
Germany	+26.1	+51.5	+18.8
<u>Singapore to:</u>			
US	+16.6	+5.0	+2.2
Japan	+54.2	+54.3	+21.4
UK	+42.7	+50.5	+24.8
Germany	+49.1	+68.7	+28.2

* December 1982 - beginning of US upswing

** March 1985 - beginning of US dollar's decline

*** January 1986 - start of export-led recovery in the NICs

the lows in February 1986. The deterioration in South Korea's competitiveness only commenced in April, and since then the loss has been miniscule. Despite a 7.1% appreciation against the US dollar between January 1986 and August this year, the real effective exchange rate actually fell, by 1.7%.

The divergence in changes in competitiveness amongst the NICs is reflected in last year's export prices in local currency terms; Taiwan's fell by 10.6%, Japan's by 14.5%, while Korea's and Hong Kong's rose by 1.3% and 1.5% respectively. In the case of Japan and Taiwan these developments reflect the ability of manufacturers to use the domestic market to cross subsidise the export market - in both cases the terms of trade gain was not fully passed on to consumers. However, the terms of trade gains are now over. As is typical in the latter stages of the cyclical upswing capacity constraints are beginning to emerge in the major industrialised nations and the investment cycle is beginning to get underway, resulting in rising material prices.

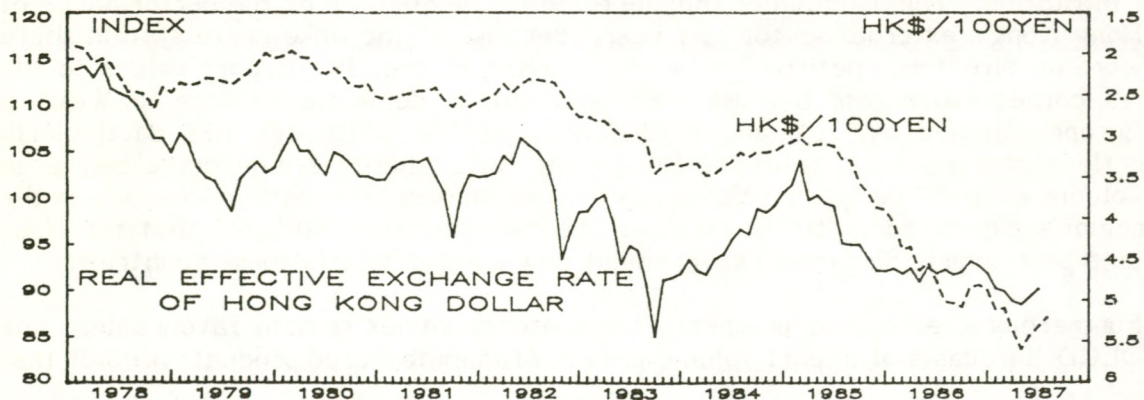
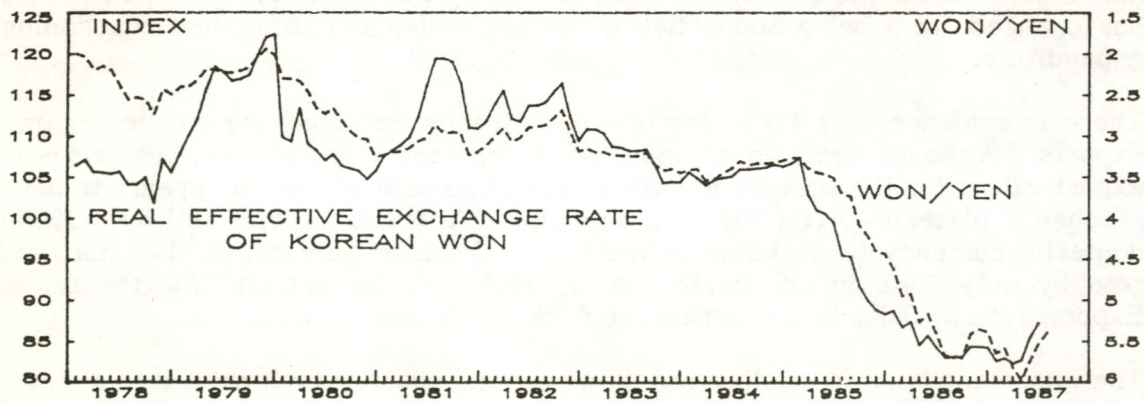
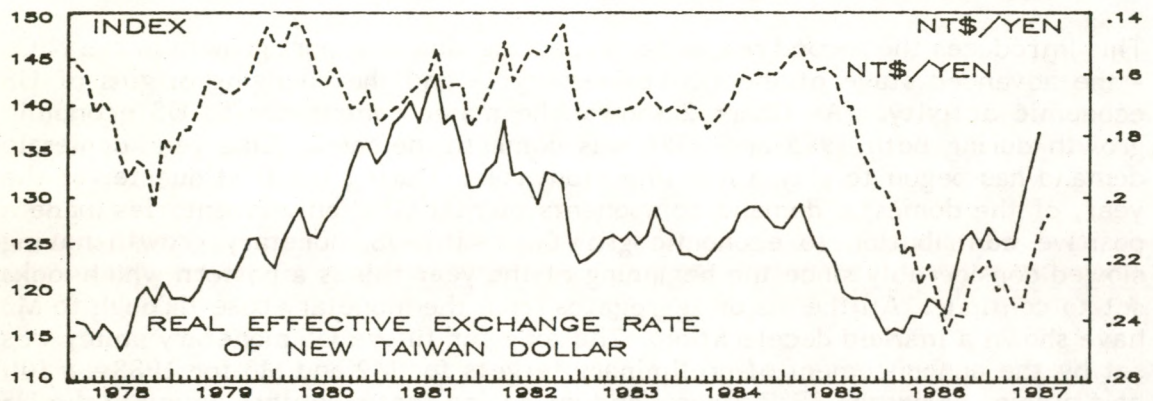
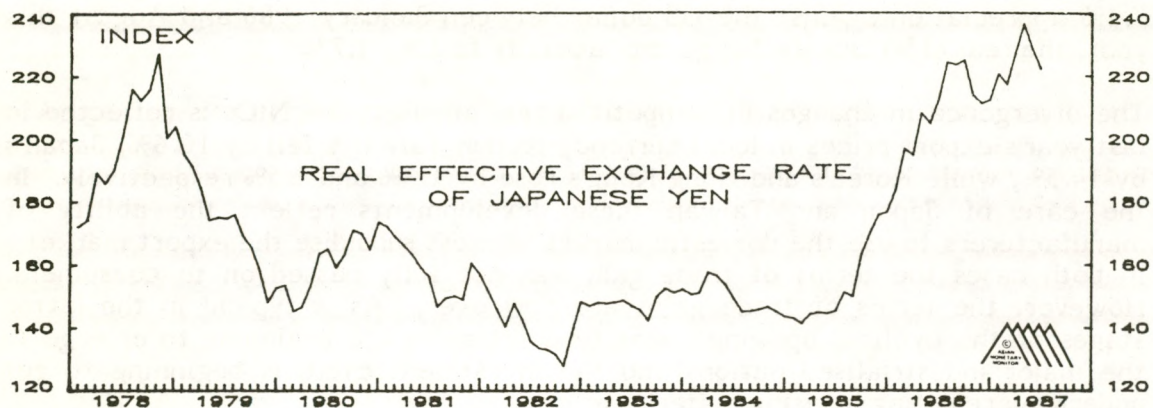
This introduces the second reason for expecting slower export growth in the NICs - the advanced stage of the US business cycle and the changing origins of US economic activity. As Chart 2 shows, the major contributor to US economic growth during both 1985 and 1986 was domestic demand. This year domestic demand has begun to play a less important role. During the first quarter of the year, of the domestic demand components of real GNP only inventories made a positive contribution to economic growth. With US monetary growth having slowed considerably since the beginning of the year this is a pattern which looks set to continue. All the major aggregates from the monetary base through to M3 have shown a marked deceleration. The tone for future US monetary policy was set by the announcement of preliminary targets for M2 and M3 for 1988 - a full half a point below the 1987 range - and indicating that monetary policy in the US has changed from being supportive of domestic demand to at best restraining expenditure.

There is evidence that these factors may already be impacting on the region's exports. Although both Korea and Taiwan reported large year-on-year rises in export values for the first six months of 1987, the rate of growth appears to have reached a plateau. After seasonal adjustment Taiwan's exports fell by 1.3% in domestic currency terms between the first and second quarters of the year, and rose by only 7.4% in US dollar terms. In Korea the pattern was the same. Exports rose by 3.1% in won terms and 6.7% in US dollar terms.

The important issue is whether any slowdown in export growth turns into a major contraction. This is unlikely and the reason is highlighted by the performance of Hong Kong's external sector last year. Because of the linked rate system there were no direct competitive gains to exporting to the US. Export values to the US consequently rose by just 5%. In contrast domestic exports to Western Europe climbed by 31% and to Japan by 38.7%. Although this particularly reflects the depreciation of the Hong Kong dollar there were nevertheless large volume gains. The grid on the opposite page showing theoretical changes in the region's export competitiveness over the current cycle indicates that the NICs (and particularly Singapore) still remain very competitive in these countries.

Furthermore, economic prospects for these countries remain favourable. The OECD forecasts of import volume growth of manufactured products predict that

CHART 3: NICs AND JAPAN
REAL EFFECTIVE EXCHANGE RATES AND
THE JAPANESE YEN



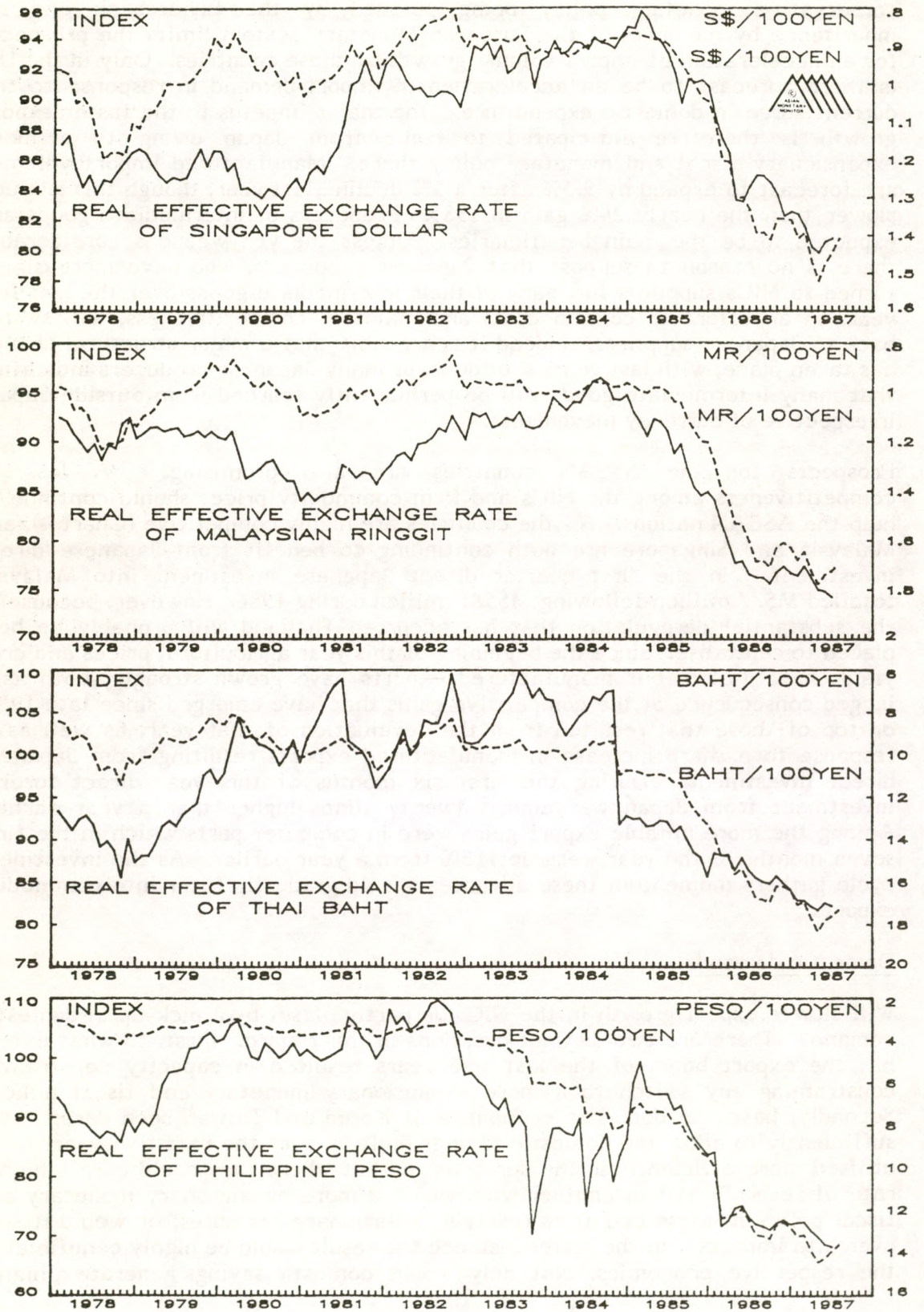
import growth among the big seven major industrialised nations will accelerate from 3.5% this year to 4.5% in 1988. Significantly, though, the extent to which the region's economies benefit will be dependent upon inter-regional trade. The conservative monetary policy being pursued by the Bundesbank and its inheritance by members of the European Monetary System limits the prospects for an acceleration of import volume growth by these countries. Only in the UK is there forecast to be an acceleration in import-demand in response to the current surge in domestic expenditure. The major impetus to the faster export growth is therefore anticipated to come from Japan owing to a more expansionary fiscal and monetary policy there. Manufactured import volumes are forecast to expand by 9.5% after a 5% decline last year, though this is much slower than the nearly 24% gain in 1985. Producers of intermediate goods are expected to be the main beneficiaries. Unless the yen weakens considerably there is no reason to suppose that Japanese producers, who have increasingly turned to NICs suppliers for many of their intermediate goods over the last few years in an effort to contain costs and maintain competitiveness, will switch back to Japanese suppliers. Indeed it is arguable that a major structural change has taken place, with last years shut down of many Japanese producers indicating that many intermediate goods will be permanently sourced from outside Japan, irrespective of currency movements.

Prospects for the ASEAN countries are also promising. A loss of competitiveness among the NICs and firm commodity prices should continue to help the ASEAN nations. All the countries are highly competitive (Chart 4), and Malaysia and Singapore are both continuing to benefit from Japanese direct investment. In the first quarter direct Japanese investment into Malaysia totalled M\$77 million following M\$581 million during 1986. However, because of the substantial deregulation that has occurred Thailand will probably be best placed to capitalise. Since the beginning of this year agricultural prices and crop yields have fallen, but manufactured exports have grown strongly, both as a lagged consequence of the competitive gains that have emerged since late 1984, on top of those that resulted from the devaluation of that year, as well as in response to a sharp increase in manufactured exports resulting from Japanese direct investment. During the first six months of this year direct foreign investment from Japan was almost twenty times higher than a year earlier. Among the more notable export gains were in computer parts which in the first seven months of the year were up 113% from a year earlier. As the investment cycle gathers momentum these advances should gradually filter into commodity exports.

Domestic demand

Will slower export growth in the NICs be partly offset by a pick-up in domestic demand? There are two distinct questions in this regard. First, to what extent has the export boom of the last two years resulted in capacity constraints, constraining any switch to a more expansionary monetary and fiscal policy? Secondly, have the domestic economies of Korea and Taiwan been deregulated sufficiently to allow the domestic savings built up over the past five years to be utilised more efficiently in the domestic market where they could earn a higher rate of return? Put in another way, would a more expansionary monetary and fiscal policy in these countries result in inflationary pressures, or would it spill over into imports? In the latter instance the result would be highly beneficial to the respective economies. Not only would domestic savings generate a higher

CHART 4: ASEAN
REAL EFFECTIVE EXCHANGE RATES AND
THE JAPANESE YEN



return, and help to relieve any bottlenecks that may develop, but in that the large current account surpluses would be reduced a major source of trade friction would be removed.

In Hong Kong's highly open laissez-faire economy the second question does not arise. But the export boom clearly has resulted in strains on existing resources. Industrial production rose by over 25% year-on-year in the first quarter and labour bottlenecks have begun to develop. Temporary solutions, such as the extension of deadlines on certain public housing projects, have been implemented and wages are rising, increasing by a real 3.6% year-on-year in the first quarter. Consumer demand is also buoyant as a result of buoyant wages reinforced by the wealth effects of surging property and stockmarkets. In the second quarter real retail sales were 10.3% up on a year earlier.

These developments have led many observers to become more cautious on the economy, fearing the emerging bottlenecks will necessitate a correction. In this respect the only sign of economic overheating that is important is a deterioration in the balance of payments. Because the Hong Kong note issue is linked to the US dollar reserves of the exchange fund, monetary policy does not exist. The money supply is passive, responding to changes in demand for either money or credit. Fiscal policy also remains largely neutral. Any correction the Hong Kong economy will need to undergo will therefore reflect an automatic adjustment mechanism, as the current account deteriorates in response to a loss of competitiveness or an acceleration in import demand. Interest rates will rise to above world market levels to attract capital inflows to finance the shortfall. Economic activity will slow and prices will eventually begin to rise at a rate which is equal to or slower than the rest of the world.

However, the prospects of an exceptionally large current account shortfall seem remote. As Chart 3 shows although the competitive edge of the Hong Kong economy begun to diminish in April, last year's more than 10% gain in competitiveness is far from being reversed. Further, it is likely that the 10% gain in competitiveness is understated, not only because the fixed weightings of the real effective exchange rate do not fully take account of the increasing importance of the European markets, but also because the increasing location of Hong Kong enterprises in Guangdong province is serving to relieve bottlenecks and substantially lowering unit wage costs. A sharp contraction in the level of economic activity originating from balance of payments constraints therefore is unlikely during the next year.

In the case of Singapore the recovery is at a far earlier stage and therefore serious bottlenecks have yet to develop. In fact although evidence suggests that unemployment has fallen to levels which could be considered to represent frictional unemployment and consumer spending is picking up, capacity remains plentiful, particularly in the property sector. In Korea and Taiwan, however, there are clear worries not only over whether domestic demand will accelerate but also over inflationary pressures.

In Korea inflationary pressures are becoming increasingly apparent. During the first eight months of the year consumer prices rose at an annualised rate of 5.8%. Although higher oil prices account for some of the rise, it is notable that the rise occurred in spite of a reduction in the consumption tax levied on some

CHART 5
JAPAN AND THE NIC'S EXPORT VALUES
12-MONTH MOVING AVERAGE

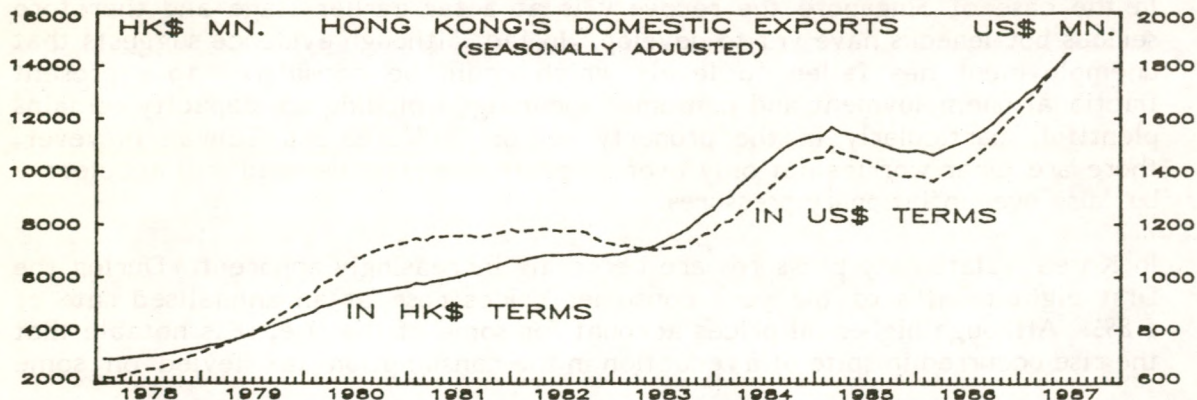
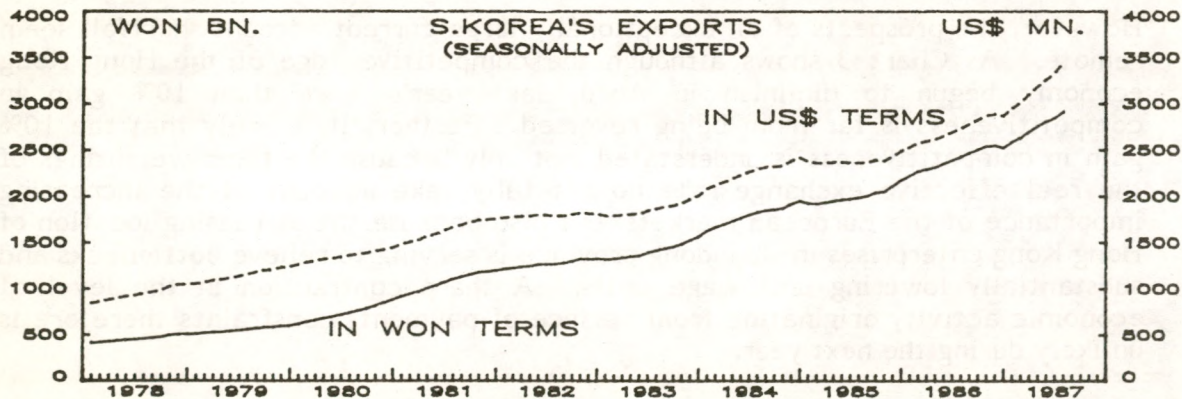
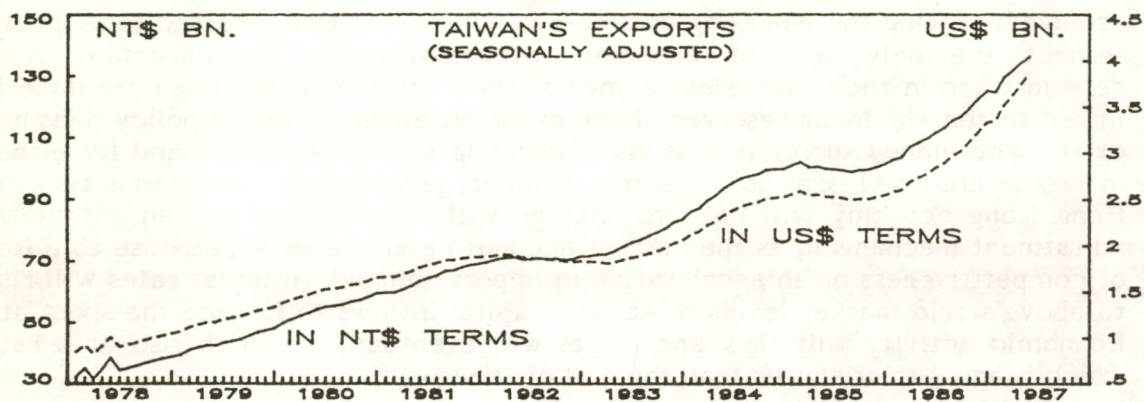
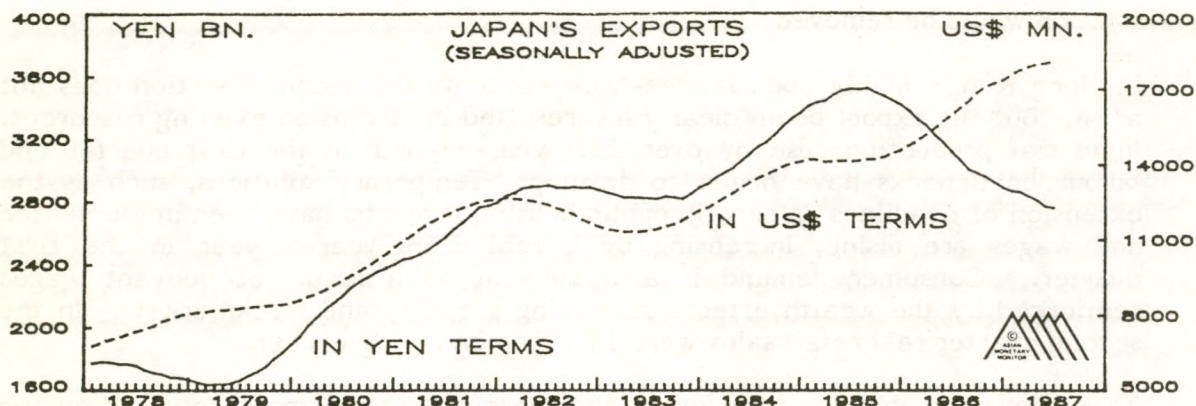


CHART 6
ASEAN EXPORT VALUES
12-MONTH MOVING AVERAGE

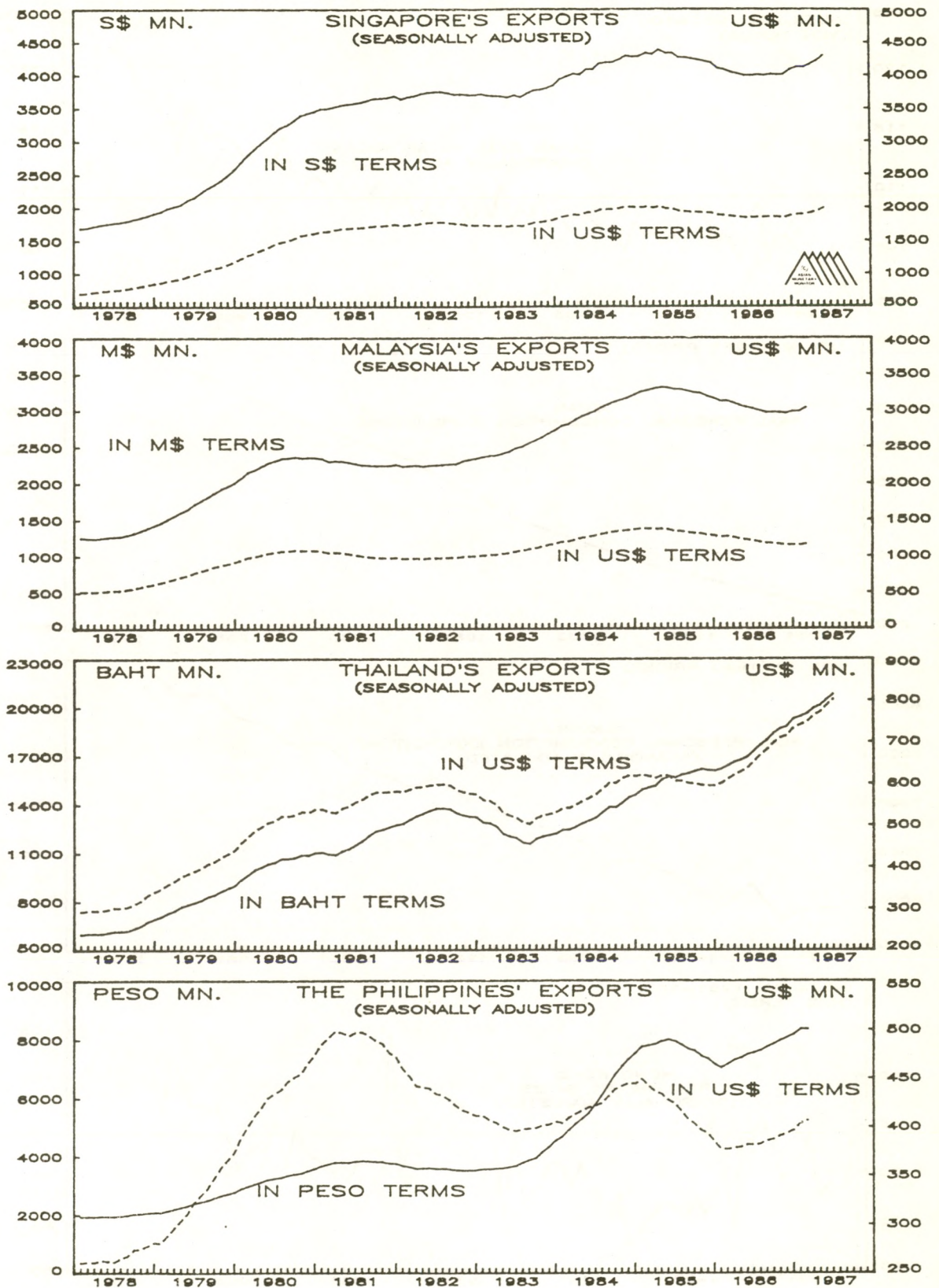


CHART 7
DOMESTIC DEMAND IN JAPAN AND THE NICs

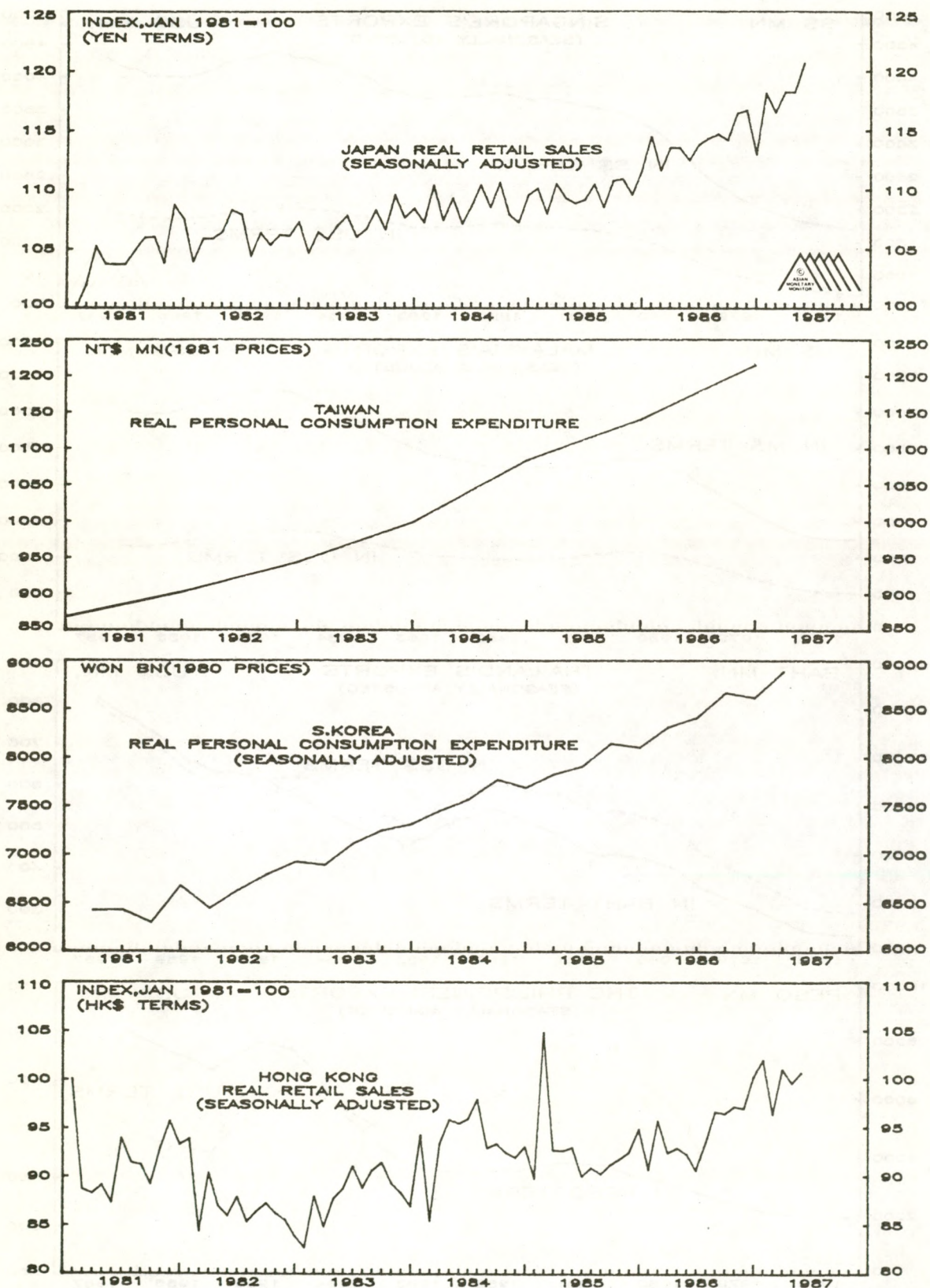
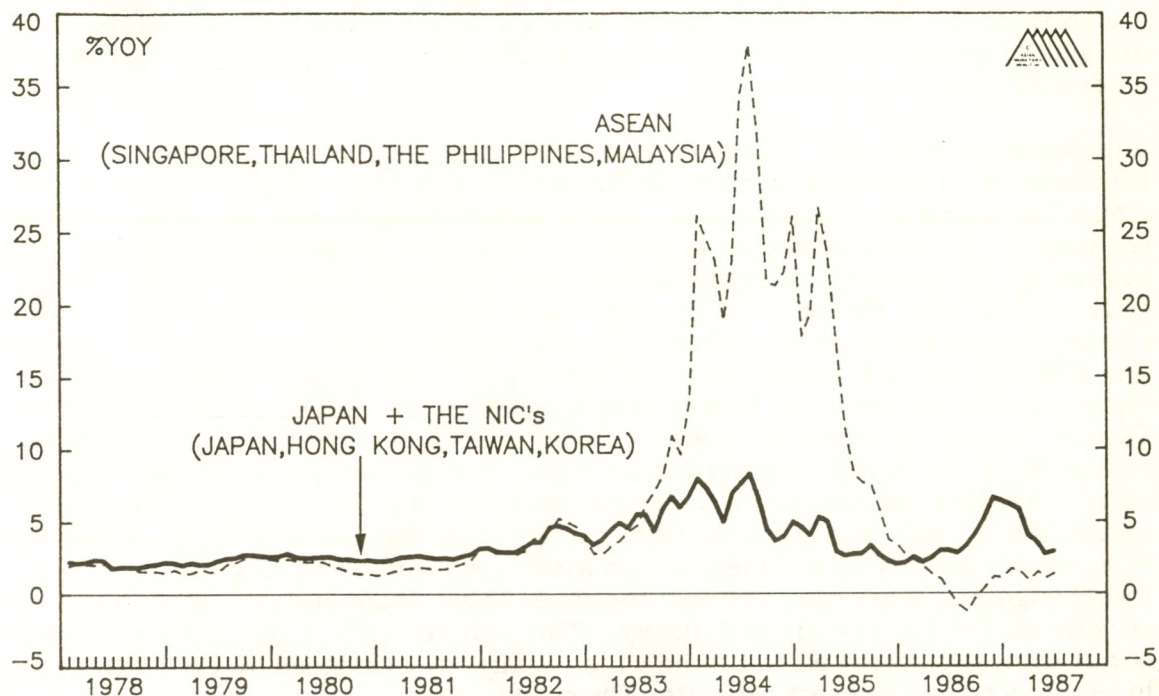


CHART 8
CONSUMER PRICES IN ASIA



'luxury goods' and a government directive to reduce prices on a range of basic items, including electricity. Although the measures were designed to restrain inflationary pressures, the major impact may be initially to raise discretionary incomes, thereby boosting consumption expenditure. Rapid money supply growth would seem to confirm this.

Despite an active programme of stabilisation bond issues - a net Won 5 trillion were issued in the first half of 1987 against Won 2 trillion for the whole of 1986 - money supply (M2) growth is likely to continue to run at the top end of its 15-18% target range. The earlier Won 1.3 trillion policy loan to farmers, which substantially boosted the reserves of the banking sector, has been followed by an additional Won 500 billion in relief to victims of the recent typhoons. However, the overriding reason for expecting consumer demand to be buoyant is the change in political climate which is expected to temporarily reverse the secular decline in the income velocity of circulation of money. This has had two impacts on the consumer. First, the industrial unrest for higher wages and the conciliatory political response is likely to result in a bigger factor share of national income going to remuneration, thus boosting purchasing power. Second, political exhortations to check 'profligate' consumer spending, which have encouraged a very high level of personal saving and contributed to South Korea's extraordinary high level of national savings, have diminished as the political climate has altered.

Any gains in domestic demand, however, are likely to be temporary and unlikely to endure for long after the election this year and the Olympic games next year. Domestic bottlenecks which up to now have been masked by government directives to reduce prices should become increasingly clear later next year as

the growth in the economy and the government's policy of breaking up the power of the chaebol highlight the need for a more efficient distribution system. In this respect relaxation of controls on imports will be vital. Although the prohibitions on the range of goods which can be imported into Korea was marginally relaxed earlier this year and tariffs reduced slightly, the barriers to trade still remain substantial.

The same is true for Taiwan. But while the immediate prospects for an acceleration in domestic demand in Taiwan are less sanguine than in Korea, the longer term prospects would seem better if the relaxation of exchange control regulations in July, albeit as a result of pressure from the US, marks the beginnings of further deregulation of the broader economy. The current difficulty is that the solution lies as much in eliminating restrictions to the effective adjustment of the current account surplus as in freeing capital flows. The alternatives are either that the current account surplus is diminished via higher import volumes, or that a continuation of an appreciation of the New Taiwan dollar eventually brings about the adjustment, in the process substantially damaging Taiwan's export base. The domestic economy will also be hurt. As long as there are expectations that the New Taiwan dollar will appreciate - and the size of the current account surplus is contributing considerably to this view - the problem associated with sterilising the build-up in the foreign exchange reserves will continue, notwithstanding recent restrictions on speculative inflows of 'hot' money. This will result in a monetary crowding out of domestic borrowers - a trend which is already evidenced by the recent rise in real short-term interest rates (see Chart 9).

ASEAN Countries

How will the ASEAN countries be affected by these developments? As previously mentioned, Singapore, Thailand and Malaysia have already benefited substantially from Japanese direct investment, and in the case of Thailand and Malaysia there is evidence that Taiwan is also setting up manufacturing plants in these countries. In Malaysia the incentives for foreign investment have been increased, and some of the restrictive guidelines on foreign ownership contained within the New Economic Policy have also been relaxed. However, because the basic objectives of the New Economic Policy remain intact and capacity remains plentiful, the propensity to invest remains weak (see AMM Vol. 11 No. 3).

A similar set of circumstances is evident in the Philippines. After improving marginally during 1986, government estimates put expected real GNP growth this year at 6%. Private consumption expenditure is leading the recovery with many companies granting wage increases of up to 50%. However, the nature of economic growth is imbalanced. Export growth is virtually flat and the current account returned to a small deficit early this year, after being briefly in surplus during 1986. Investment is also weak, a reflection of the low level of capacity utilisation. But the biggest obstacle to a pick-up in investment is the slight bias in economic policy towards the distribution rather than the creation of wealth. The land reform bill which threatens to disrupt the economic production of certain crops is one example. The delay in passing a bill granting the go-ahead for a range of companies to be privatised is another.

CHART 9
JAPAN AND THE NICs : REAL SHORT TERM MONEY MARKET RATES

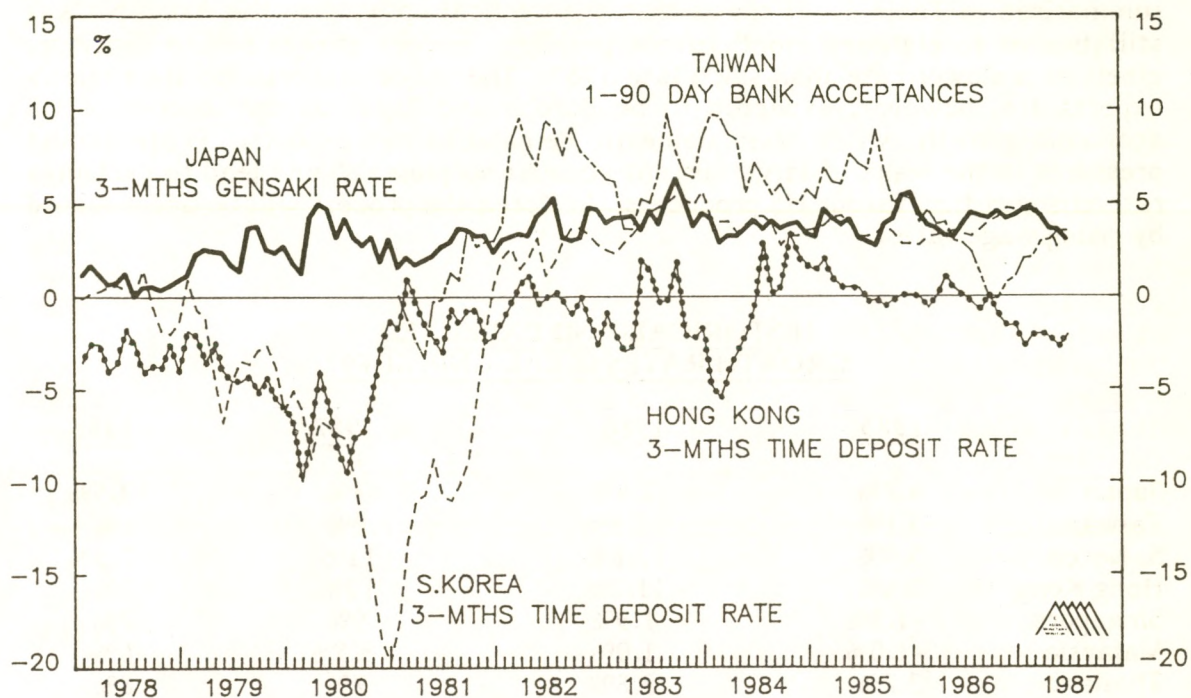
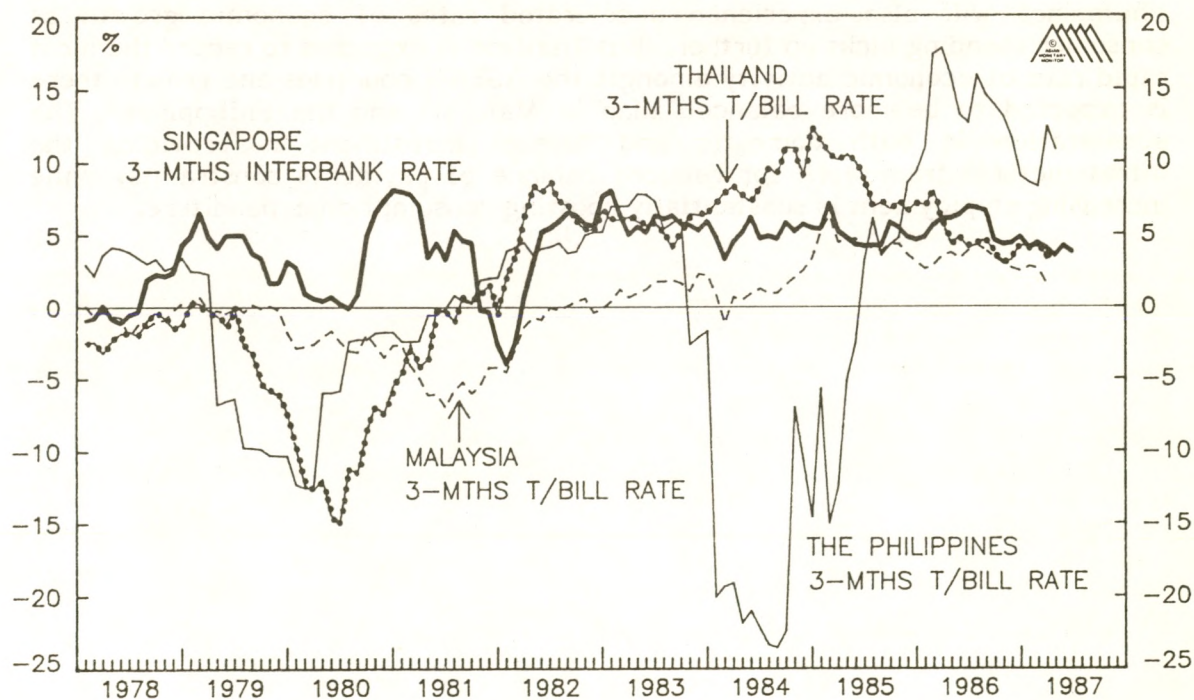


CHART 10
ASEAN : REAL SHORT-TERM MONEY MARKET RATES



Conclusion

The implications of these developments for the region's economies are summarised in Table 1. It shows that the cyclical upswing in the Asian NICs is still twelve to eighteen months from peaking. Export growth should continue, albeit at a slower rate than since late 1985. The major markets for the region's exports are, however, expected to be Europe and Japan as the sources of US economic growth switch from domestic demand to net exports. Protectionist pressures in the wake of large current account surpluses should lead to exchange rate changes that favour US producers. In Korea the process will be accentuated by rising wage rates.

HISTORICAL AND EXPECTED GROWTH RATES (REAL GNP/GDP)

	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>
Japan	4.7%	2.4%	3%	3.5%
Taiwan	5.1%	10.8%	9%	6%
S. Korea	5.4%	12.6%	11%	7.5%
Hong Kong	0.6%	11.2%	12%	8%
Singapore	-1.8%	1.9%	9%	7%
Malaysia	-1.0%	1.0%	3.5%	4%
Thailand	3.7%	3.8%	7%	8%
Philippines	-3.8%	0.1%	6%	5%

Nevertheless, the NICs are likely to continue to record the best rates of economic growth in the region. Domestic demand will remain strong in Hong Kong, and strengthen in Korea and, to a lesser extent, Taiwan. Malaysia and the Philippines will also experience accelerated rates of economic growth as consumer spending picks up further. But Thailand is expected to record the most rapid rate of economic activity amongst the ASEAN countries and growth there is expected to be more balanced than in Malaysia and the Philippines. The acceleration in both domestic and foreign investment is providing the infrastructural framework for reduced balance of payments constraints, while increasing employment is substantially boosting consumption expenditure.

JAPAN: THE EFFECT OF RISING INTEREST RATES ON INSTITUTIONAL FLOWS OF FUNDS

Since its low in May the yield on the benchmark ten year Japanese government bond has risen by nearly three percentage points, to stand at close to 5.5% in early August. It may be that the sharp rise in Japanese long-term interest rates has been a temporary phenomenon, the result of trend - following trading by Japanese bond market participants. However, if the recent jump in yields instead has signalled a major change in the direction of Japanese interest rates which owes itself to more fundamental influences - namely a stronger domestic economy and associated rising rate of return to investment in Japan, and perhaps rising inflationary expectations - then there could be major implications for the flow of funds in Japan and, in turn, for the rest of the world. In this article we examine the pattern of the flow of funds in Japan with particular reference to the role of the major Japanese institutions in the flow of funds, and briefly consider the implications of rising Japanese interest rates.

The investment behaviour of the major Japanese institutions was discussed in an article in the previous issue of AMM (AMM Vol. 11 No. 3). This paper was primarily concerned with the portfolio decisions of the institutions - particularly the life insurance companies - and the relationships with the yen/dollar rate and interest rate differentials between Japan and the US. The article made use of an analysis of the 'break-even exchange rate' for investment in US treasuries versus Japanese government bonds to illustrate the comparatively obvious, but often overlooked, point that in general Japanese institutions will be bigger investors in foreign securities the higher is the level of the yen (for any given interest rate differential). However, in being concerned primarily with shifts in portfolio distribution (i.e. essentially stock adjustments) the article did not address the flow of funds aspects of institutional overseas investment. Here, the analysis presented in the previous article is extended to give a more comprehensive picture of the economic role played by the Japanese institutions.

Most financial analysis of Japanese institutional investment in foreign securities is concerned largely with inflows of funds into the institutions, the implication usually being that the larger are the institutions' inflows of funds at any time, the greater will be their investment in foreign and other securities, and hence the stronger will be the securities markets and the weaker the yen. In purely economic terms this type of analysis could be argued to be misguided. Japan has a large current account surplus which grew sharply in 1986 as a result of the terms of trade gain Japan enjoyed from falling commodity prices and the strong yen (see AMM Vol. 11 No. 1). The rise in the current account surplus represents an increase in the size of the savings-investment gap, or financial surplus, for the economy. By definition this financial surplus, or net acquisition of financial assets, is invested overseas (i.e. it represents a capital outflow from Japan) and essentially the Japanese financial institutions are only acting as a conduit for this investment. Seen in this light it might even be argued that an increased flow of funds into the Japanese financial institutions could mean a stronger, rather than a weaker, yen because the flow of funds would be associated with a rising current account surplus. Further, there need not be any

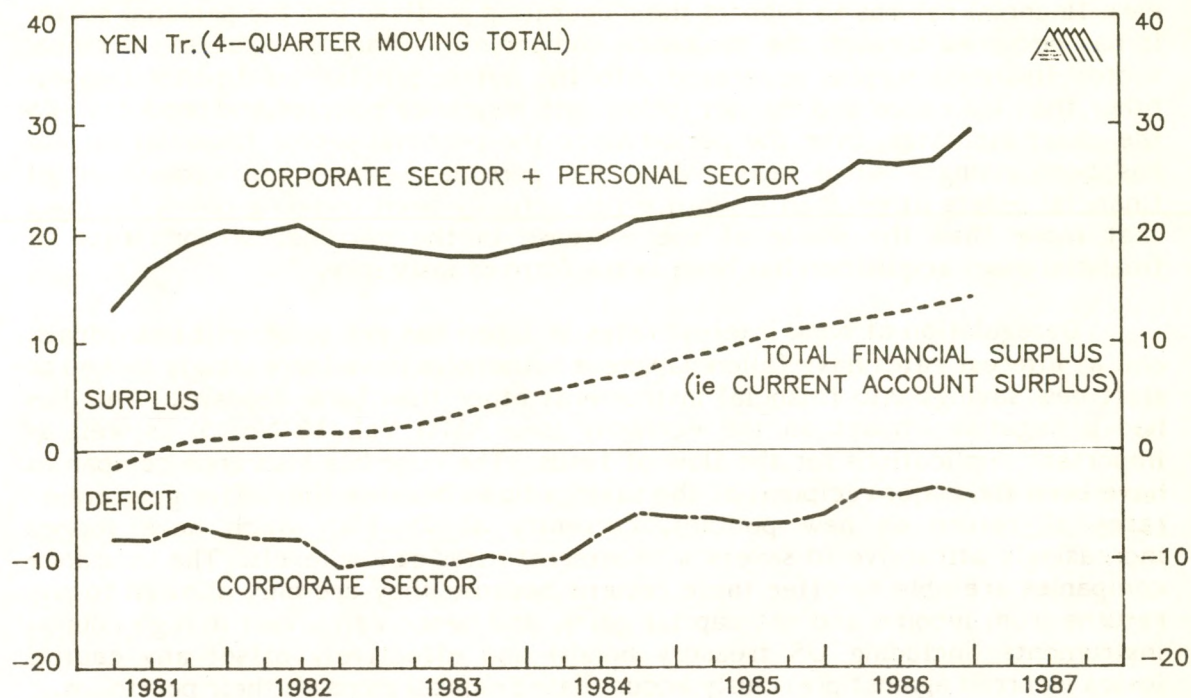
implication for the total of global liquidity available for investment in financial markets (unless the Bank of Japan intervenes in the foreign exchange markets and other central banks do not), as only the worldwide distribution of liquidity is affected.

Some light can be shed on these arguments from an examination of the Japanese flow of funds and from some simple observations on the nature of the Japanese institutions. Chart 1 shows the net acquisition of financial assets (or savings minus investment) of the corporate business and personal sectors, as well as the total financial surplus for the economy. (In flow of funds statistics the total financial surplus (or deficit) is usually recorded negatively as the 'rest of the world's' financial deficit (or surplus) so that the sum of all the sectors (including the rest of the world) then adds to zero.) In Chart 1, the central bank, private financial and public financial institutions sector, as well as the government and public corporations sectors have been excluded because these sectors have been less important in flow of funds developments since 1984. Instead, as the chart indicates, the increase in the current account surplus over that time has been reflected in an improvement in the financial positions of the personal and corporate sectors, while the financial deficit of all the other sectors taken together (represented on the chart by the gap between the corporate sector plus personal sector and the total financial surplus, and comprising, most importantly, the public sector) has remained roughly constant. From the chart it can be seen also that this has constituted an improvement in the financial positions of both the corporate sector and personal sector, the corporate sector's financial deficit narrowing since early 1984 while the personal sector's financial surplus (the gap between the corporate sector plus personal sector and the corporate sector line) has increased since late 1984.

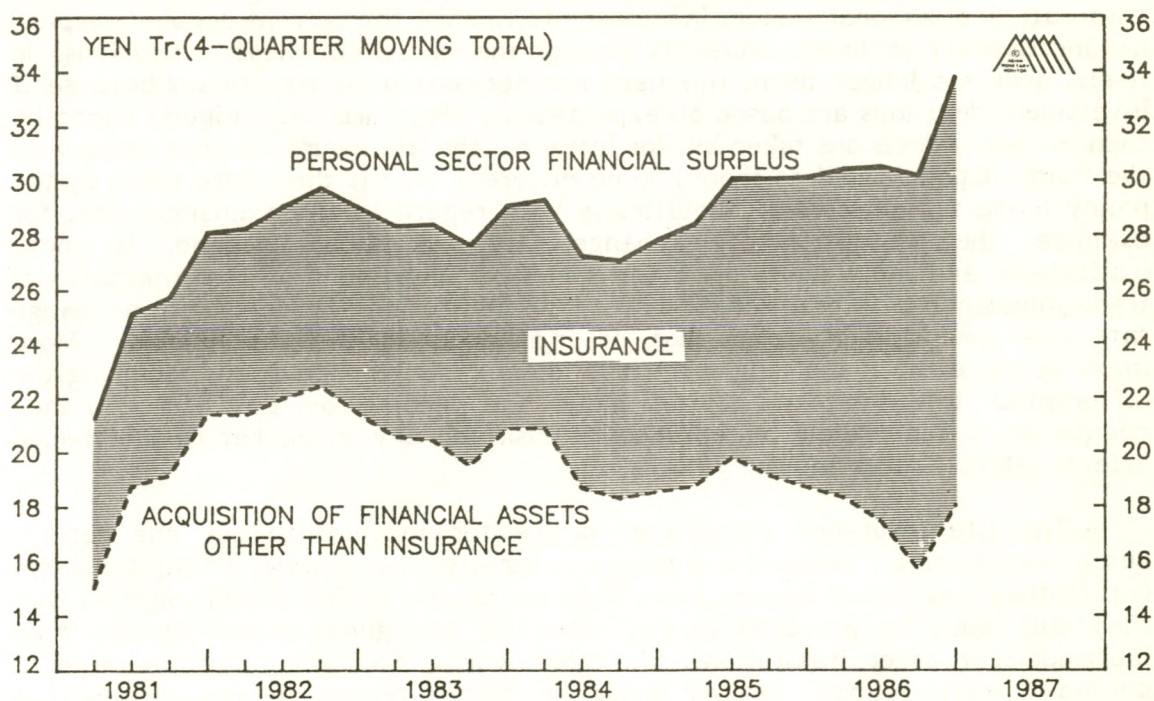
The process through which the rising current account surplus over 1985 and 1986 benefited the financial positions (i.e. increased savings relative to investment) of the corporate and personal sectors is relatively easy to understand. The increase in the current account surplus occurred as Japan's terms of trade improved with falling commodity prices (particularly oil) and the strong yen. The corporate sector retained most of the benefit from the terms of trade improvement, as lower industrial input prices were not passed on in the form of lower prices to the consumer. Corporate free cash flow also increased as a result of general cost-cutting and rationalisation, and a sharp reduction in business investment - in plant and equipment and inventory - as companies strove to remain competitive in the face of the rising yen. With business savings (i.e. retained post-tax profits plus depreciation) supported by the terms of trade gain, while investment was sharply curtailed, the corporate sector financial deficit (or net acquisition of financial liabilities) narrowed. The personal sector did obtain some benefit from the sharp improvement in Japan's terms of trade as the rate of increase in prices slowed somewhat (albeit by much less than suggested by the fall in import prices). The personal sector saved most of the consequent improvement in real income in 1985 and 1986, thus increasing its rate of acquisition of (net) financial assets.

More important than the way in which the growing current account surplus translated into increased acquisition of financial assets by the personal and corporate sectors is the way in which this acquisition of financial assets has become 'institutionalised' (taken here to mean intermediated with the overseas

JAPAN: CHART 1
FINANCIAL SURPLUS FOR THE ECONOMY



JAPAN: CHART 2
THE PERSONAL SECTOR FINANCIAL SURPLUS



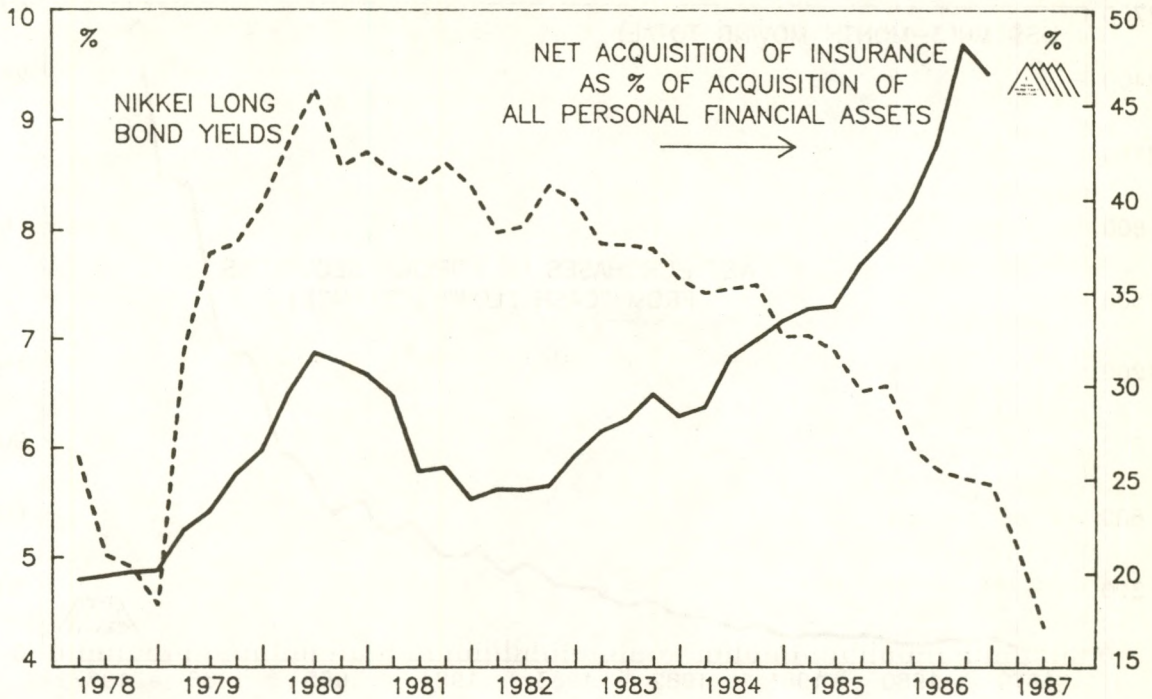
sector via institutions other than directly through the banks). For the corporate sector this has occurred through the growth of trust accounts, as companies have set up tax-efficient Tokkin and fund trusts to manage their financial assets and earn financial returns to support their operating profits. For the personal sector it has occurred through the insurance companies. Chart 2 shows the personal sector financial surplus separated into the net acquisition of financial assets other than insurance and the net inflow into insurance policies and products. As the chart indicates, over the period since the personal sector financial surplus has been rising - since late 1984 - the personal sector's net acquisition of financial assets other than insurance has actually been trending down, meaning that more than the whole of the increase in the personal sector's rate of financial asset acquisition has been in the form of insurance.

Deregulation of bank interest rates in Japan has yet to benefit individuals, and as interest rates have fallen Japanese households have increasingly looked to shift new savings into financial instruments other than bank deposits. This has had a negative impact on the economy (see AMM Vol. 10 No. 5) as well as important implications for the flow of funds. The huge life insurance companies have been the major recipient of the savings flows because they offer guaranteed rates of return on new policies, currently at 7%-8%, which have looked increasingly attractive to savers with interest rates at low levels. The insurance companies are able to offer these returns because they are only allowed to pay returns from income and not capital gains, and hence can invest in high coupon instruments (including US treasury bonds) and effectively offset any capital losses incurred against previously accumulated capital gains on their portfolios.

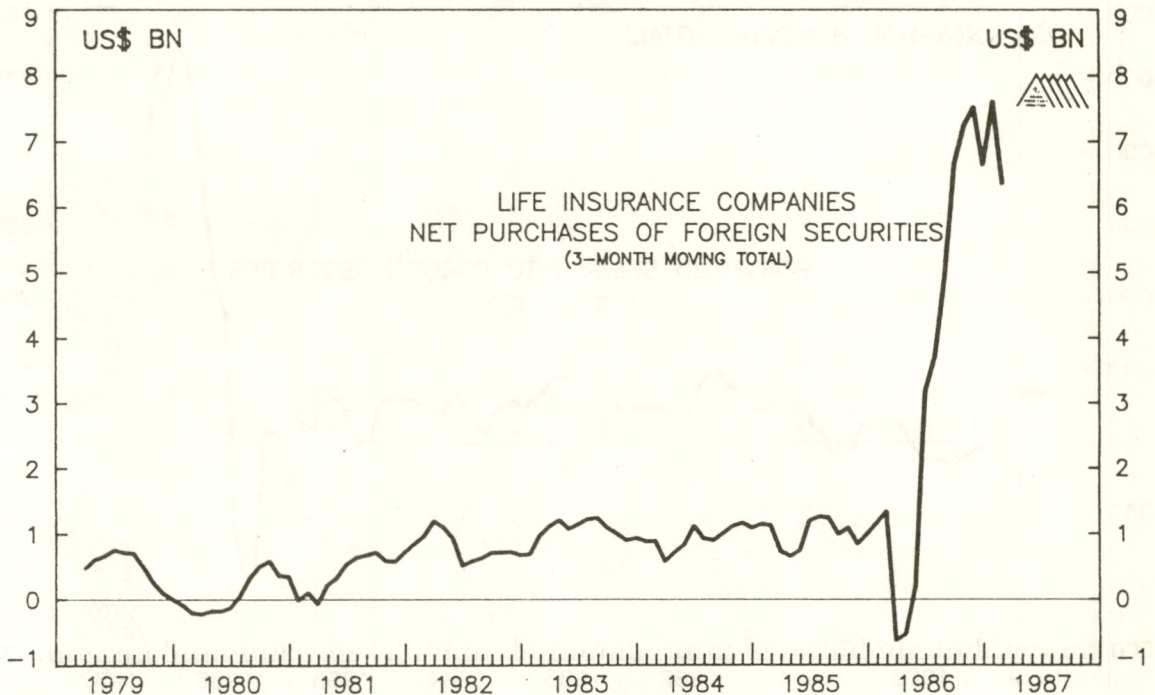
Thus, as the Japanese current account surplus and the yen have risen and interest rates have fallen, savings have increasingly been shifted into trust accounts (by companies) and insurance companies (by the personal sector - see Chart 3), meaning that the necessary acquisition of foreign assets by the corporate and personal sectors (necessary to finance the current account surplus) has increasingly occurred indirectly through the medium of these institutions. In itself, over the longer term, this need not necessarily be significant because if investment decisions are based on expectations which are determined rationally, then in theory decisions taken by, for instance, the life insurance companies with the funds of policy holders should be no different than if they were taken by the policy holders themselves. Specifically with regard to the exchange rate, for example, the perception of exchange rate risk should depend, for both institutions and individuals, upon the speed of adjustment of the international trade imbalances. In practice, however, the institutions' perception of exchange rate risk could differ from that of individuals in the short-term. More importantly, even in the long-term it is likely that the regulations requiring the differential treatment of capital gains and income by the life insurance companies distorts their acceptance of risk for any given return and hence affects interest rates and the yen.

The life insurance companies' desire for income (to pay the returns guaranteed to policy holders) and their comparative insensitivity to capital losses (which they can offset against gains they are unable to distribute) suggests that they will likely be prepared to pay more for any given income stream than individuals or other institutions. In other words, they should be prepared to purchase high coupon foreign bonds at higher prices, in yen terms, than

JAPAN: CHART 3
PERSONAL NET ACQUISITION OF INSURANCE

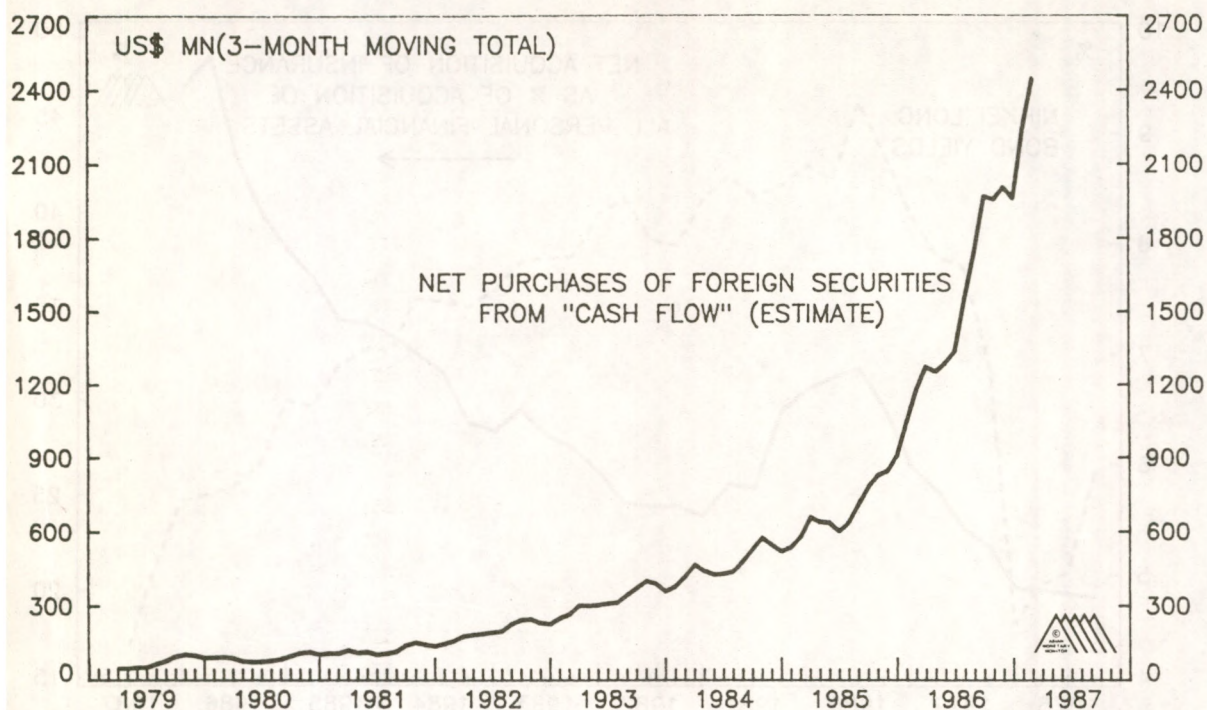


JAPAN: CHART 4
LIFE INSURANCE COMPANIES INVESTMENT IN FOREIGN SECURITIES



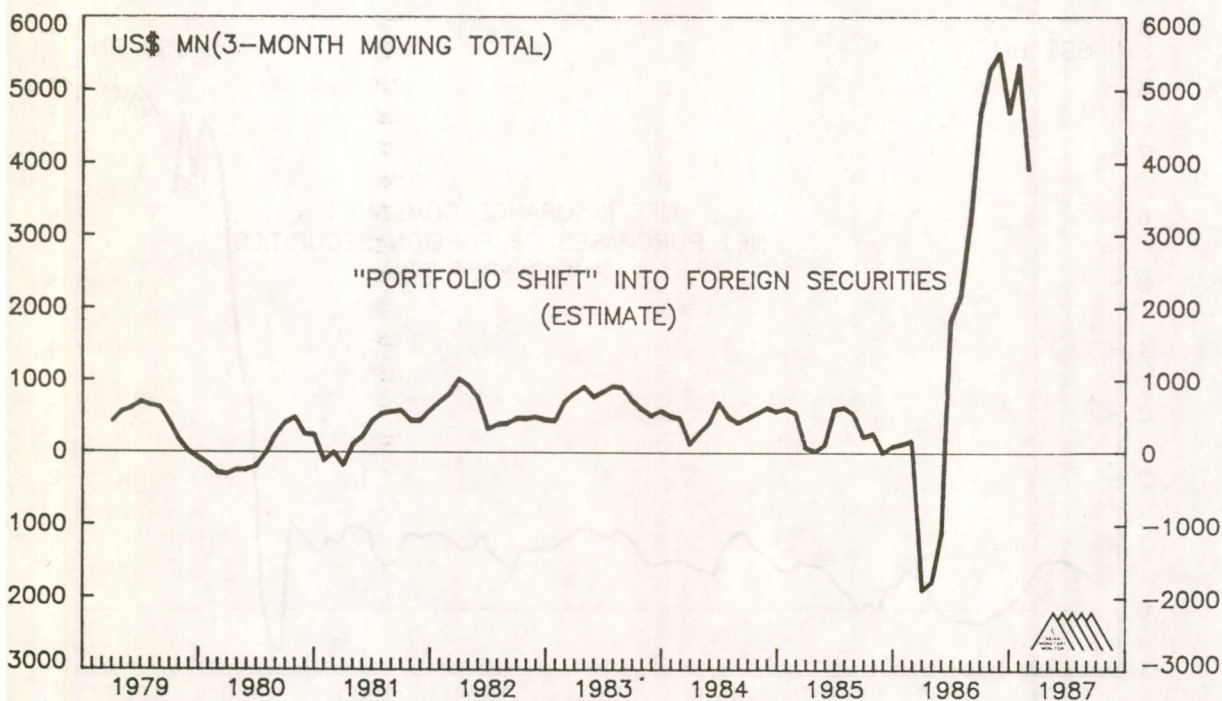
JAPAN: CHART 5

LIFE INSURANCE COMPANIES SECURITIES INVESTMENT



JAPAN: CHART 6

LIFE INSURANCE COMPANIES SECURITIES INVESTMENT



individuals left to themselves or other institutions would be. If this is the case, then increased flows of funds into the insurance companies could tend to be a factor supporting foreign currencies (i.e. weakening the yen) because life insurance companies would be 'more willing' (i.e. they would be prepared to accept greater risk of capital loss for a given income return) to invest in high coupon foreign securities than the individuals or entities from which they originally obtain the funds.

In Charts 5 and 6 life insurance companies' net investment in foreign securities has been separated into an element which can be attributed to the rising cash flow into the companies and the element which then represents purely the change in the distribution of their total assets, towards a greater proportionate weighting in foreign securities. The investment in foreign securities from 'cash flow' is estimated as being the rate of investment which would occur in any given month if in that month the life insurance companies acted to maintain the percentage of their total assets invested in foreign securities at the same level as in the previous month (i.e. cash flow investment in month N = total cash inflow in month N x (total holdings of foreign securities in month N - 1 ÷ total assets in month N - 1)). The increase in 'cash flow' purchases of foreign securities for any month then depends only on the rate of total cash inflow, although the level of 'cash flow' investment over time (as calculated here) will be cumulatively affected by the trend increase in the percentage of total assets invested in foreign securities. This latter element - the 'portfolio shift' into foreign securities - is shown in Chart 6, where it is calculated as the residual ('portfolio shift' investment in month N = total investment in month N - 'cash flow' investment in month N) and represents investment in foreign securities attributable purely to the increase in the weighting of foreign securities in the life insurance companies' total portfolios.

This separation of investment into a cash flow component and an asset distribution element is obviously very artificial but from it can be drawn some rough conclusions. Net purchases of foreign securities from cash flow (Chart 5) appear to have accelerated very smoothly since 1981, with the result that the overall profile of the portfolio shift, or asset redistribution, into foreign securities (Chart 6) remains very similar to the overall profile of total investment in foreign securities over the period (i.e. the sum of the series in Charts 5 and 6, shown in Chart 4 for reference). As a general rule it can be postulated that the cash flow investment, because it depends on the total flow of funds into the life insurance companies from the personal sector, will depend to a large degree upon the level of Japanese interest rates, or specifically upon the difference between market interest rates and the rates guaranteed by the companies to their policy holders. Thus the acceleration in the series since 1981 can be explained by the constant decline in Japanese interest rates over that period (see also Chart 3). The 'portfolio shift' into foreign securities, on the other hand, should largely be determined by the attractiveness of investment in foreign securities relative to investment in domestic assets, which is a function of interest rate differentials between Japan and the rest of the world, and the level of the yen. The jump in foreign securities investment as a result of asset redistribution in 1986 can then largely be explained by the strength of the yen during that year, which made foreign securities appear increasingly 'cheap' (see AMM Vol. 11 No. 3).

The shift in portfolios towards a greater weight in foreign securities can be seen to have been the most important factor behind the sharp increase in life insurance companies' net purchases of foreign securities in 1986. However, the increase in investment from 'cash flow' - from roughly US\$1 bn per quarter at the end of 1985 to roughly US\$2 bn per quarter at the end of 1986 - was not insignificant. This latter element can be deemed to have possibly led to an institutional distortion of the markets. If Japanese market interest rates now rise towards the 7% rate guaranteed by the life insurance companies to their policy holders and inflows of funds into the insurance companies consequently dry up, as policies no longer appear an attractive investment, then this 'cash flow' investment should be expected to drop towards zero. The market distortion arises because it is not clear that this capital outflow would then be replaced by the personal sector itself - either directly or indirectly - at the ruling interest rate differentials and exchange rate, because individuals are not constrained by the approach to capital gains necessary for the insurance companies (as explained earlier) and therefore will not have the same risk/reward preference. In short, it is likely that in this event either foreign interest rates would have to rise relative to Japanese rates and/or the yen would have to strengthen to induce a capital outflow to 'replace' the 'lost' capital outflow, all other things remaining equal.

FORECAST: If the Japanese domestic economy continues to strengthen and, perhaps, inflation begins to trend upwards slightly, then interest rates in Japan will tend to rise, in line with the rising nominal return to investment. This would then have some obvious consequences for the flow of funds in Japan. Business investment in plant, equipment and inventory should pick up, meaning that the corporate sector financial position (i.e. corporate savings minus corporate investment) will deteriorate. This would imply a reduced flow of funds into Tokkin and fund trusts, in turn meaning a reduction in capital outflows from this institutional source. An important by-product might be a relatively weaker domestic equities market, as the domestic securities markets are generally the first choice of Tokkin and fund trusts, overseas securities markets finding favour with the trust accounts when relative valuations in Japan appear too high.

The personal sector financial surplus should also tend to fall as consumer spending rises, possibly meaning some reduction - or at least a plateau - in the rate of cash inflow into the life insurance companies. The declining personal and corporate sector financial surplus would be a natural part of a declining financial surplus for the whole economy (i.e. current account surplus), which would occur as imports gathered strength. The institutional role in this type of process is only that of an intermediary, and the consequences for the yen and interest rates would depend on whether it is the demand for capital or the demand for imports within Japan which has the greatest tendency to rise.

Institutional factors would play a larger part if market interest rates rose towards the critical 7%-8% level representing the rate of return guaranteed by the insurance companies. Then, inflows of funds into the insurance companies could drop more dramatically and suddenly. In the event that inflows fell away to nothing (theoretically quite possible) then US\$2.5 bn per quarter (i.e. close to US\$10 bn at an annual rate - from Chart 5) of capital outflow would need to be 'replaced'. Other things being equal, it might take a stronger yen and higher

foreign interest rates relative to Japanese interest rates than would otherwise be the case to induce this capital outflow.

EPISODES FROM ASIAN MONETARY HISTORY

FREE BANKING IN FOOCHOW

by George A. Selgin

Assistant Professor of Economics, George Mason University

Introduction

In a world in which currency is mainly issued by central banks, Hong Kong stands apart: currency is supplied by two private banks (the Hong Kong and Shanghai Banking Corporation and the Standard Chartered Bank), and the government does not exercise any discretionary control over the money supply. Many commentators find this remarkable, and more than a few are convinced that Hong Kong would be better off if its currency were supplied by a central bank, following the pattern set by other industrialized economies.

Most people are unaware, however, of numerous precedents that lend support to the approach taken by Hong Kong. In the 19th century currency in several nations was issued by private firms. In Sweden, Canada, Scotland, and New England (in the United States), where private issues were most free from government interference, they functioned smoothly and efficiently. These instances contradict the conventional opinion that centralized banking and currency supply are inherently superior to free (decentralized) banking.

But one does not have to look as far as Europe or North America to find examples of successful free banking. One may also look to mainland China, where free banking was the official policy for most of the Ching Dynasty. Although banking under the Manchus was subject in many places to local and provincial regulations, in others it was entirely free. One such case was the banking system of Foochow, the capital of Fukien province. From the beginning of the 19th century until the second quarter of the twentieth Foochow's banking and currency system was entirely private and free from any regulatory restrictions.

General Monetary Arrangements in 19th Century China

China's monetary system in the 19th century included three different units of account, each with its own exchange-media representatives. The tael (of which there were many varieties - Foochow's contained 532.5 grains of silver) was used in interprovincial trade and for some local wholesale trade. The dollar, based on the full-weight Mexican dollar coin, was employed in foreign trade. Finally, the copper ch'ien or "cash" was used in local retail exchange. It was represented by round copper coins (wen) with square holes in their center. The coins were used in "strings" (ch'uan) of 100 units or more. A string of 100 10-cash coins (1000 ch'ien) was once standard. However, the presence of many worn and debased coins (some minted centuries before) (1) made inclusion of more than 100 10-cash coins typical for a string valued at 1000 "standard" cash.

Although exchange-media representing 1000 standard copper cash were sometimes called "tael" units, their value fluctuated freely against that of silver monies - despite appearances to the contrary China did not have a bimetallic, copper-silver standard, but rather parallel standards. Copper-silver exchange rates varied continually both over time and across localities due to changing market conditions.

Excepting two brief unsuccessful issues during the 1650s and 1850s, the Manchu government refrained entirely from issuing paper money. But it did not interfere with private banks doing so on their own. Furthermore the bulkiness and weight of copper coin - a mule-cart was needed to move more than 10,000 cash - and its uneven, fluctuating quality, created exceptional opportunities for private issuers of paper money. Thus China entered upon an era of official laissez-faire in money and banking. In Foochow this policy gave rise to an exceptionally advanced private currency industry.

Two Groups of Banks in Foochow

During the free-banking era two groups of banks operated in Foochow - old-style or "native" banks and modern or "foreign" and "foreign-style" banks. Modern banks, which first appeared after the opening of the Treaty Ports, included all foreign-owned commercial banks and their Chinese imitators. Native banks (which were of much older origin) included "Shansi" banks - named after the province where banks of this type first opened - and "local" banks. Shansi banks were large branch banks mainly involved in interprovincial trade, including the handling of payments to and from the central government. Local banks were usually single-office firms involved in local lending and exchange only. Some, however, belonged to a distinct class - they were the "big" local banks (chien tien or tso piao fien). These issued the bulk of Foochow's monetary assets, including demand notes, current throughout the city. They were also members of the local bankers' guild and clearing association. The other "small" local banks issued notes current only within their immediate proximity and trading elsewhere at varying discounts. Small banks did little lending, concentrating on the exchange of different kinds of money. Consequently they were also known as "money shops," "cash shops" or "exchange shops". Some small banks also reissued notes of larger banks, and many operated as sidelines of other businesses.

Notes issued by the chien tien included "cash" notes and, beginning in the second half of the 19th century, "Dai-Fook" dollar notes. Cash notes were issued in denominations ranging from 400 to several thousand cash. Dai-Fook notes were issued in denominations of one to fifty "dollars", where \$1 Dai Fook = 1000 "standard" copper cash. Foreign banks, established after 1845, issued notes representing standard (full-weight) silver dollars.

Because cash notes were widely preferred to coin in retail exchange, retail prices were typically expressed in amounts of standard cash, and actual worn coin was accepted at discount.

Growth of the Banking Industry

Local banks were already present in Foochow in the 18th century. Most

began as money exchange shops, which then undertook the issue of non-circulating promissory notes ("native orders") to well-known merchants. Promissory notes of more reputable firms were often assigned and circulated. This led to banks issuing bearer notes, which were often cashed on demand. Some local banks may also have been set-up by Shansi bankers, to supplement their parent firms by specializing in local transactions.

Local banking grew rapidly in the beginning of the 19th century, so that by 1815 local banks' notes were widely used. The opening of Foochow to foreign trade following the Opium War gave the industry a further boost, both by increasing the demand for convenient and reliable currency and by introducing "modern", foreign banks. The modern banks issued silver-dollar-denominated demand notes, and this encouraged more of the local banks to make their copper-based notes redeemable on demand. Foreign banks also accepted local bank notes in payment, directly enhancing their market. By 1847 local bank notes, especially notes redeemable on demand, had almost entirely displaced copper coin.

By the last part of the 19th century there were 30 local banks with over \$500,000 (silver) in capital each, and hundreds of smaller firms. By 1922 there were 46 chien tien in Foochow, issuing Dai-Fook notes exclusively (cash notes having passed out of use by the end of the 19th century). In that year Cantonese (Nationalist) troops occupied Fukien, causing many local banks temporarily to close their doors and suspend payments as a precaution against forced loans to the invading army. Though most of the banks recovered, the large Bank of Fukien (which was banker to the provincial government) failed leaving \$1,000,000 of its notes unredeemed. Responsibility for these notes was taken by the remaining chien tien through a new agency formed by them expressly for the purpose called the Association for the Maintenance of the Money Market, which issued its own redeemable notes in place of those issued by the Bank of Fukien. Also in response to the crisis, the bankers guild of Foochow, called the Native Bankers Association, froze its membership. This fixed the number of chien tien at 45, permitting new entry into the guild only in the event of the failure or voluntary closure of an existing member-bank. Overhead costs for existing chien tien were also increased: these now included a fee of \$600 payable to the Chamber of Commerce, and a \$3000 contribution to the common pool established by the Association for Maintenance of the Money Market to support its notes issued in exchange for the unredeemed notes of the Bank of Fukien.

In 1927, the 45 banks, plus the Association for the Maintenance of the Money Market, still had 10,000,000 Dai-Fook dollars outstanding. A year later, however, the Nationalist government abolished the popular Dai-Fook unit, requiring all notes to be denominated in standard silver dollars. This reform was strongly opposed by the banks, to the point of provoking them to go on strike. It reduced the advantage of bank notes over cash in local exchange, because most prices were still expressed in terms of copper units (cash or Dai-Fook dollars). This caused many local banks to abandon their note issues, to become mere exchange-shops or close down entirely. By 1931 only 20 note-issuing local banks remained. These, in turn, were forced to give up their note-issues by the Nationalist government as it prepared to give the Central Bank of China a monopoly in note issue. The encroachment of these regulations is described below.

Organisation and Operation of Local Banks

Local banks were unlimited liability firms, usually of two to ten partners, although some were individual proprietorships. They could be set up by anyone with the necessary capital without a charter or any kind of permission from the government. To become a chien tien, however, a bank had to gain admission to the clearing house and bankers guild. This required that the new bank throw an elaborate feast for the directors, staff, and brokers of its established rivals, to establish goodwill. The new bank also had to pay a membership fee to the guild.

Local banks' revenues came from speculating on exchange-rate movements (especially silver-cash exchange rates), from issuing demand notes (which sold at a premium of 0.5% to 1.5%) in exchange for copper cash, from cashing notes of other banks for a fee, and from making loans. In granting loans local banks emphasized the creditworthiness of borrowers rather than documentary formalities, which was opposite to the practice of foreign and foreign-style Chinese banks. Borrowers' backgrounds were carefully investigated by street-runners. Often a borrower had to be recommended by a reputable third party, who also served as a guarantor. Family ties were very important.

Loans based on personal credit were not completely unsecured. Borrowers sometimes had to have unborrowed accounts at the lending bank, like contemporary "compensating balances". Banks could also confiscate the goods of a defaulting borrower. The security here was the borrower's general property rather than specific collateral.

Of the two kinds of native orders only demand notes circulated widely, the rest sometimes being limited to their street of issue. Demand notes appear, moreover, to have been the only kind of promissory notes commonly in use in Foochow, and the only kind issued by chien tien, the local banks having discovered that refusing to cash their notes on demand could seriously erode public confidence in them. They may also in some cases have been encouraged by the example set by foreign banks.

Local bank notes were usually payable in copper cash, or in silver at the request of the note holder. In emergencies, however, banks could exercise discretion in redeeming notes in gold or silver (at the current rate of exchange) or even, in the case of smaller banks, in current notes of the chien tien.

Unlike foreign and foreign-style banks, local banks observed traditional Chinese business customs. They closed only on Chinese holidays, remained open on Sundays, and had no midday closing hours. They were also known for their courteous accommodation and convenient procedure in the withdrawal of funds, which on some occasions included delivering funds by special messenger to customers in urgent need. Such service, together with widespread offices and thorough knowledge of local enterprises, made local banks more successful than modern banks in lending to small business. It also allowed them to do an exclusive business in interior regions, so that modern banks had to use them as agents for lending there.

Note Exchange and Clearing

Although small banks sometimes paid out notes of larger banks, or used them to redeem their own notes, large banks issued only their own notes, returning all others immediately on receipt in exchange for their own notes collected by rival banks or for cash. Thus, bank notes played only a limited role as high-powered money, with cash being the most important bank reserve medium. Daily note exchange was already standard practice by 1847. Large banks accepted one another's notes at par, which further served to expand the market for their notes.

Although no details are available concerning early clearing arrangements, by 1927 there were no less than five different note-clearing centers, consisting of a central clearinghouse at Shang Hang Chieh and its four branch units. Clearings were held every morning. Balances were usually settled in cash, but clearinghouse members could also delay payment, provided they paid interest to creditor banks at a rate of 25 to 50 cents per diem for every \$1000 owed. This charge was set daily by the Native Bankers Association. Banks did not, however, take advantage of emergency borrowing privileges often. The rates involved were punitive, and any bank habitually unable to pay its clearing balances was likely to face a loss in public confidence, possibly resulting in a run.

Perhaps the most important consequence of daily note clearings was that no bank could afford to be over-generous with its issues. Thus Wagel observed that "while there was no lawful check on the issue of paper by the banks, the evil of the unrestricted issue was to a large extent minimized" (2). Certainly it was less than the "evil" which had occurred in previous centuries when paper money was issued by the Chinese government.

Failures and Panics

Prior to 1922 local-bank failures were confined to small banks or cash shops. A mid-19th century observer reported that only four small banks had failed from 1844 to 1848, and that "a general crush, seriously affecting the public interest, is a thing unheard of" (3). Banks that failed usually did so just before the Chinese New Year, when many debts had to be settled causing exceptional withdrawals of cash and bullion. This put a heavy strain on weaker banks.

Banks typically failed as a result of poor management, rather than any premeditated fraud, though there were isolated cases of the latter. Defaulting banks usually paid off between fifty and sixty percent of their outstanding liabilities.

Although the public had no reason to suspect foul play on the part of bankers, this did not prevent bank runs. The insolvency of a single bank (especially at the end of the year, when other banks were also in greatest risk of default) often triggered runs on other banks suspected of being low on cash or specie. Ironically, banks' unlimited liability, which might have discouraged bank runs, seems actually to have encouraged them, because of China's special, help-yourself version of unlimited liability. According to Justus Doolittle, if a bank could not redeem its notes in cash (or some preferred medium) on the spot, the

note-holder could "seize hold of anything in the bank and take it off, to the full amount of his demands" without being liable "for prosecution for theft or misdemeanor" (4). Consequently, the disappointment of a single note holder could provoke his immediate confiscation of bank property, which would in turn thrust other bank customers (who might not originally have been after cash) into a frenzied round of "bank gutting".

Until 1855, note holders engaged in bank gutting would quickly be joined by other persons who had no legitimate claims against the run-upon banks. "Beggars and idlers" were "only too happy to assist in such an exciting and profitable hobby as robbing a bank". Once this happened, a run would degenerate into a full-scale riot: "When an excited and interested crowd has begun such a work", Doolittle observed, "it is exceedingly difficult to prevent the completion of the undertaking". It was not unusual for a bank, once run upon, to be robbed "of every portable thing worth carrying off, even to the sleepers and the rafters".

Such inadequate protection of bank property made bank runs more severe and frequent than they would have been otherwise. It also added to the losses suffered by legitimate note holders. In 1855, in the wake of a particularly severe run on several banks (including one that had not been guilty of defaulting on any of its notes before it was looted), the provincial authorities decided to put a stop to unwarranted bank gutting. They arrested several rioters, ranging from a poor coolie to a respected rice-dealer. After determining that the arrested were guilty of robbery (having held no claims against the victimized banks), the viceroy, at the risk of provoking an uprising, beheaded them, without trial, before a large crowd of other looters. According to Doolittle, this "summary act at once quelled the disorderly rabble, and no such disposition to rob a bank was manifested...for a considerable time".

Larger banks were able to protect themselves against runs. They would assist each other with emergency loans of cash, and it was not unusual for friends of a bank to rally around it during a run to maintain order and to keep looters away. Threatened banks posted signs and published notices declaring their intent to "hereafter pay" (huo chi) i.e., to redeem all their outstanding notes and not undertake any further issues. The custom developed that once a bank formally announced its plans to liquidate its assets and pay off its notes its property could not be confiscated even by disappointed holders of its notes (5).

More reputable banks, if threatened by a run, could also secure permission from a local mandarin to suspend payment. A bank that secured such permission would be closed, its doors sealed by two long strips of paper in the form of an X. The strips bore, along with other notices, the name of the responsible mandarin, who might even pledge his personal assets as security for the bank's liabilities. After being officially sealed, a bank could settle its accounts with greater leisure than would otherwise have been available to it.

Thanks to such emergency measures and to their long-standing reputation for trustworthiness the chien tien were practically immune to runs and to failure due to runs. Their record appears to have been unblemished until the crisis of 1922.

Counterfeiting

Counterfeiting of local bank notes was discouraged through an ingenious technique known as the "proof-slip" system for identifying legitimate notes. Notes were printed with extra-wide right-hand margins, on which various words, phrases, or even complete sentences would be stamped or written. Then the margins of a stack of freshly-printed and marked notes would be trimmed with a sharp knife. The trimmed-off slips of paper, bearing half of the marginal identification markings, would then be kept in a reference book after having the value and date of issue of the formerly attached notes recorded on them. If a bank had any doubt concerning the authenticity of a note presented to it for payment it could check the proof-slip to see if the identification markings matched. Thus forgeries, unless executed with such skill that their authenticity was never questioned (an unlikely possibility, considering the elaborate system of special inks and markings used in preparing legitimate notes), would be detected rapidly. This greatly increased the odds of tracing them to their source.

Thanks to such precautions forgery was seldom practiced in the earlier days of Foochow's free-banking system, despite lenient penalties typically applied to forgers. When it did occur it was on a very small scale, involving notes of small denominations (which were less scrutinized). In an exceptional case local bankers put a stop to a particularly intransigent forger by hiring him as an expert detector of other forgeries!

Following the Nationalist takeover - when former cash notes had been entirely replaced by Dai Fook dollars - counterfeiting became a more serious problem. This was due partly to the declining quality of local notes in the 20th century: the paper was poor, and the printing was less intricate and less-well executed than before. This probably reflected the general decline in prosperity suffered throughout Fukien since the 1850s, due to the collapse of its tea industry and continuing political instability.

The proliferation of counterfeits made local bank notes less convenient, as they would sometimes be refused unless declared authentic by an expert or endorsed by their tenderer (if his credit was good). Many notes were literally blackened by multiple endorsements. Yet even this did not guarantee their authenticity, for counterfeiters soon learned to add fake endorsements to their issues, which also helped to give them the appearance of having circulated for a long time. Nevertheless, despite this increase in counterfeits, Dai-Fook notes remained the currency of choice throughout Foochow. They continued to command a premium over cash until they were suppressed in 1928.

The End of the Free Banking Era

Despite counterfeiting, mounting political instability (including periodic military occupations and the continued threat of forced loans), and economic depression, the local banks of Foochow, and their note issue business in particular, remained profitable and commanded high public confidence well into the twentieth century. They had carved a niche for themselves which modern banks, both domestic and foreign, were not able to fill.

Unlike the Shansi banks, which relied on the Imperial government as their

main source of funds, local banks survived the Republican revolution, even benefitting from it by taking over some of the business formerly given to the larger native banks. The revolution also ended the Imperial banking regulations of 1907-9, meant to restrict private note issues by imposing a stiff 60% cash and specie reserve requirement, but never enforced in the south.

Ironically, the same lack of involvement with central government affairs that saved local banks from the fate suffered by Shansi banks also led to their ultimate decline. While many local bankers were inclined to support the revolutionaries, they had relatively little to offer them in the way of funds. In contrast, several modern Chinese banks lent heavily to the Republican (and later the Nationalist) government. This eventually cost local banks their right of note-issue, since "a connection" developed "between the right to note issue and the loaning of funds to the government" (6). The connection first became evident under the Republican government, which between 1913 and 1926 borrowed \$600,000,000, almost all of it from modern banks. In 1929, their last year in power, the Republicans borrowed another \$80,090,000, less than eight percent of which was lent by local banks. In return they renewed the Imperial regulatory agenda, modified to include provisions favourable to the modern banks. Besides re-implementing the 60% reserve requirement on note issue, the Republican reforms of 1915 and 1920 marked a victory for modern banks by making their notes alone receivable in payments to the government. The reforms also required banks to hold the remaining 40% of their note-backing assets in specified forms, especially including national government bonds. This also helped modern banks since they already held large amounts of government bonds and enjoyed a substantial appreciation in their value as a result of the reform. But local banks were hurt by having to cut back on profitable local loans to purchase the required bond-collateral.

Fortunately for the local banks in Foochow and elsewhere in the south, the Republican government, like the Imperial government before it, was unable to enforce its regulations in that part of the country. Only following the Nationalist takeover did regulations favoring modern banks take their toll on local banking in Foochow. Like the Republicans, the Nationalists borrowed heavily from the modern banks, especially to finance military expenditures. By 1935 they had an outstanding debt of over \$1 billion, with local bank loans accounting for less than five percent of this amount. As the Nationalist government grew, so did its financial demands from modern banks. It therefore continued Republican reforms that favored the modern banks. To promote further lending by them to it, the government put additional restraints on note-issues by local banks. An example was the prohibition of the popular Dai Fook dollar-unit in Foochow in 1928, which eliminated an important advantage possessed by local bank notes over modern, silver-dollar-denominated notes.

Other regulations directly enhanced the powers of modern banks. The most important of these, enacted on November 3, 1935, made the notes of the three largest modern-style banks - the Central Bank of China, the Bank of China, and the Bank of Communication - full legal tender or fa-pi currency. The Central Bank of China, which had been the main fiscal agent to the Nationalist government since being rechartered in Shanghai by that government in 1928, was given the sole right of unrestricted legal-tender issue. The authority given to the other modern banks to issue legal tender notes could be rescinded at any

time by the Ministry of Finance.

While notes of modern banks were made legal tender, the use of silver as money was declared an act of treason. Silver coin and bullion had to be turned in to the Currency Reserve Board of the Ministry of Finance, or to one of the legal-tender issuing ("official") banks, in exchange for legal tender notes (7). The former 60% specie-reserve requirement became a de facto 60% legal-tender reserve requirement. This meant that the official banks could expand their issues without confronting any sort of liquidity constraint.

The immediate circumstance provoking these reforms was the continuing loss of silver reserves by modern banks and by the Central Bank of China in particular. This was largely due to the American Silver Purchase Act of 1934. But the government may have had another motive for abandoning the silver standard, which was its desire to continue securing large-scale loans from the modern-style banks. In the event, the official banks were quick to take advantage of the new reform. In just over one and one-half years their combined note-issues increased almost four-fold, from \$427,414,917 to \$1,607,202,334. Prices expressed in yuans, which in terms of silver had fallen 21% in the three years before the reform, rose 43%. Soon afterwards China experienced yet another instance of government paper money becoming utterly worthless.

It is significant that local banks, had they been allowed to adhere to a copper standard, would have been immune to fluctuations in the value of silver that threatened modern banks. Sir Arthur Salter observed that "while silver slumped heavily in 1930 and 1931, coppers rose in terms of the standard silver dollar. On the other hand, when silver rose from 1931 to 1935, coppers depreciated considerably. Thus, China's copper currency has been more closely related to the general international movement of prices than China's silver currency" (8). Although actual copper currency was phased out in many parts of China, copper-silver exchange quotations continued to be used to make cost-of-living adjustments in contracts specifying payment in silver.

A final provision in the new reform prohibited local banks from extending their note issues. Their outstanding notes were to be gradually retired and replaced by notes of the Central Bank of China. The goal of the Ministry of Finance was to give the Central Bank of China a monopoly in note issue. However, this plan was interrupted by the outbreak of the Sino-Japanese War, and it became a dead letter when the Communists gained power in 1949. From then on the Communist People's Bank became the focus of monetary reforms, gradually taking over the branches of the Central Bank of China as well as local bank offices. By the mid 1960s, local banks had been completely phased out. Private notes disappeared along with them.

Or did they? According to a report in the Far Eastern Economic Review of April 11, 1957, Communist financial experts were perturbed by their discovery in the late 1950s that Agricultural People's Cooperatives (APCs) throughout the country were illegally issuing large quantities of small-denomination bearer notes (to make up for insufficient issues of small notes by the People's Bank). Government officials were reluctant to take steps against the APCs, for fear that the publicity would inspire more of them "to adopt the expedient to solve their own difficulties". The government did, however, issue a statement in the

People's Daily denouncing the unauthorized note issues as a "Capitalist crime".

Conclusion

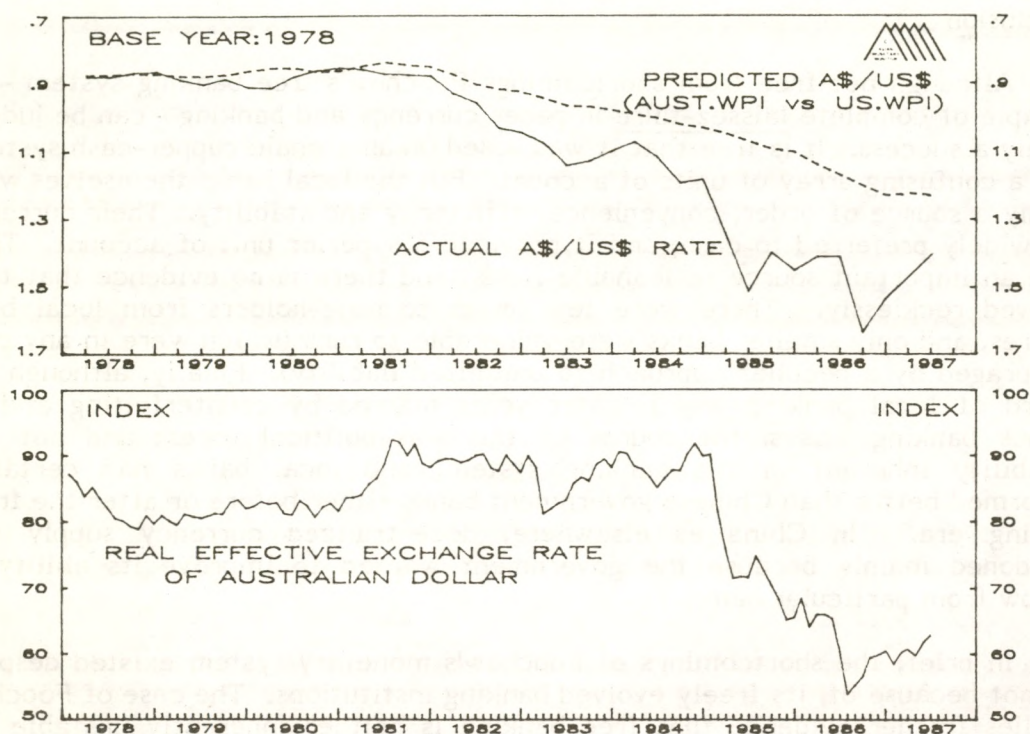
Although not free from shortcomings Foochow's free banking system - an example of complete laissez-faire in paper currency and banking - can be judged largely a success. It is true that it was based on an archaic copper-cash system, with a confusing array of units of account. But the local banks themselves were mainly a source of order, convenience, efficiency and stability. Their currency was widely preferred to cash, and it provided a superior unit of account. They were an important source of loanable funds, and there is no evidence that they behaved recklessly. There were few losses to note-holders from local bank failures, and only smaller banks were vulnerable to runs (which were in any case encouraged by a peculiar approach to unlimited liability). Finally, although the record of local banking was in later years marred by counterfeiting and by serious banking crises, the source of this was political unrest and not any instability inherent in the banking system, and local banks had certainly performed better than Chinese government banks either before or after the free-banking era. In China as elsewhere, decentralized currency supply was abandoned mainly because the government wanted to improve its ability to borrow from particular banks.

In brief, the shortcomings of Foochow's monetary system existed despite, and not because of, its freely evolved banking institutions. The case of Foochow supplies further evidence that free banking is neither inherently unstable nor inferior in practice to centralized banking. Perhaps it will provide food for thought to those who currently advocate further centralization of currency supply for Hong Kong.

NOTES

- (1) Though they allowed private issues of paper currency the Manchus maintained an official - and highly unsatisfactory - monopoly in coinage.
- (2) Srinivas R. Wagel, Chinese Currency and Banking, Shanghai, 1915, p. 177.
- (3) Sir Harry Parkes, "An Account of the Paper Currency and Banking System of Fuchowfoo". Journal of the Royal Asiatic Society, 1952.
- (4) Justus Doolittle, Social Life of the Chinese, vol. 2, New York, 1965.
- (5) Following the 1911 revolution the bankruptcy law was revised and bank gutting became formally illegal.
- (6) Andrea Lee McEldery, Shanghai Old-Style Banks, 1800-1935, Ann Arbor, 1976.
- (7) The establishment of the Exchange Fund in Hong Kong was undertaken in sympathy with these reforms on the mainland.
- (8) Arthur Salter, China and Silver, New York, 1934.

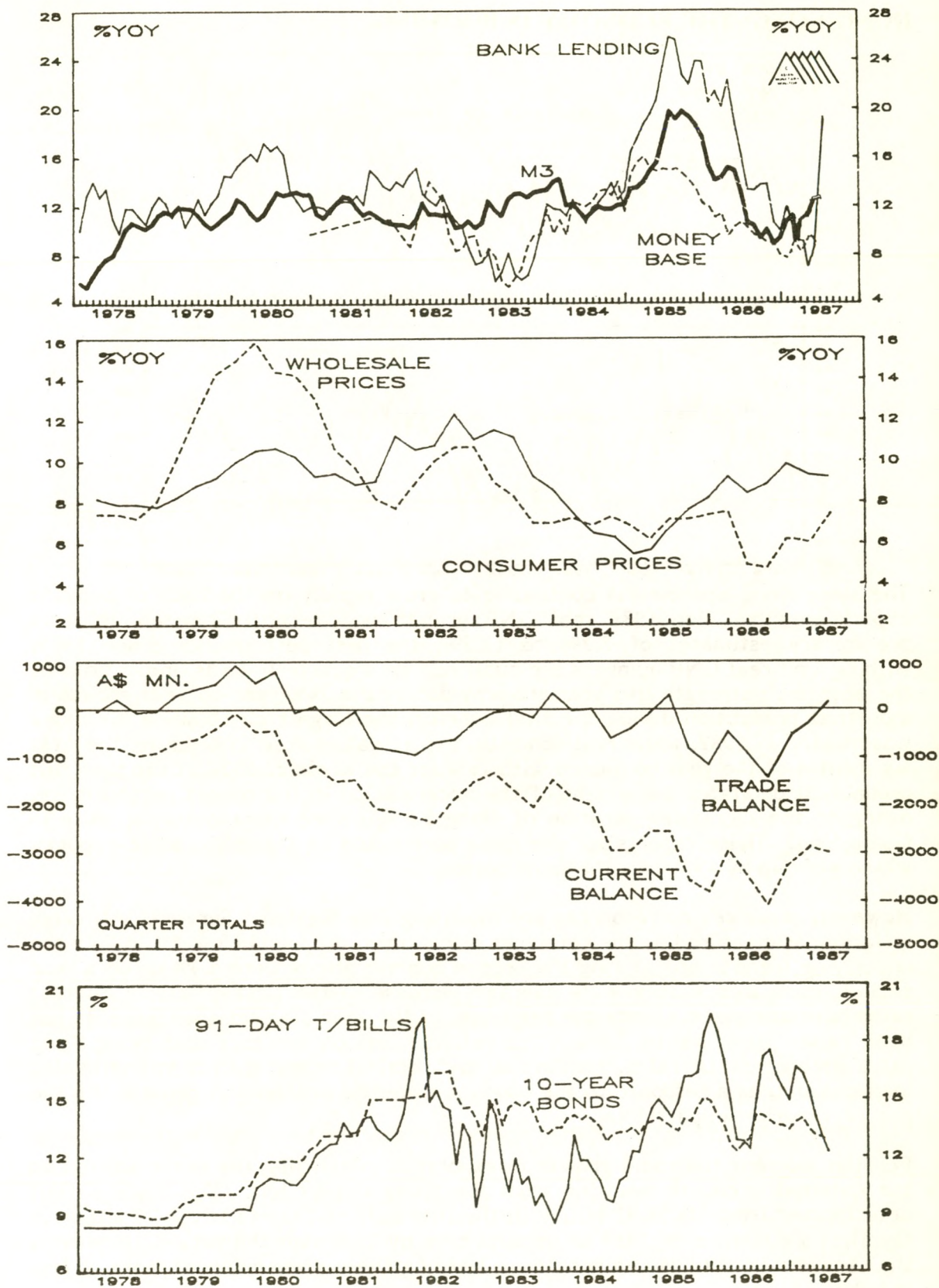
AUSTRALIA: THE YIELD CURVE TURNS POSITIVELY SLOPED



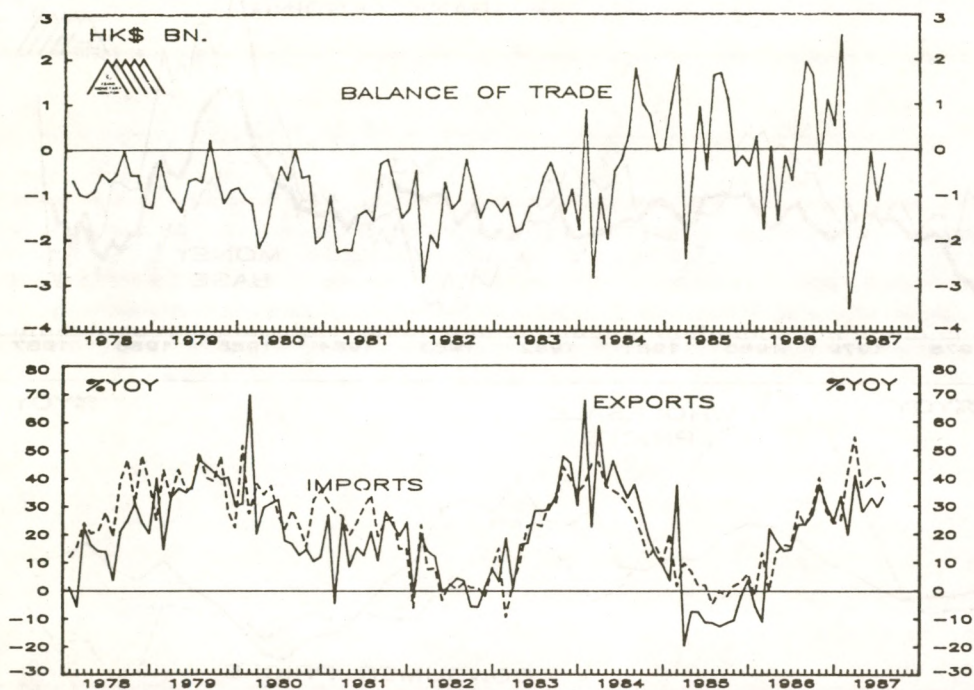
Except for a brief period in the middle of 1986, short term interest rates in Australia have been higher than long term rates since the beginning of 1985. This inverted yield curve has been a sign of monetary stringency. Last year short rates fell below long rates briefly when the Reserve Bank attempted to loosen its monetary policy. This premature loosening caused a collapse in the A\$ and forced the Reserve Bank to tighten once again.

In June 1987, short term rates finally dipped below long rates as shown on the accompanying chart. This movement has a better chance of lasting than last year's temporary move. The main reason is that in the present case the Reserve Bank has been a reluctant participant in the loosening instead of the main instigator. 1987 has seen the internationalization of the A\$ with a large and growing Euro-A\$ market, the start of A\$ futures trading at the Chicago Mercantile Exchange, and large speculative interest in both A\$ bonds and Australian stocks. Part of this interest is because industry has been cutting costs, the government has deregulated, and per unit labour cost increases have been falling. All of these factors have helped to strengthen the currency above where the authorities, and certainly the private sector, would prefer it to trade.

Australia has a large foreign debt requiring net factor payments. This necessitates a currency which is undervalued relative to purchasing power parity. The strengthening of the currency in real terms threatens to prevent Australian industry from completing its restructuring. This is probably the reason the Reserve Bank felt constrained to allow a loosening in monetary conditions in order to keep the currency from appreciating further. This action increases the risk of future inflation.



HONG KONG: THE ECONOMY IS BOOMING

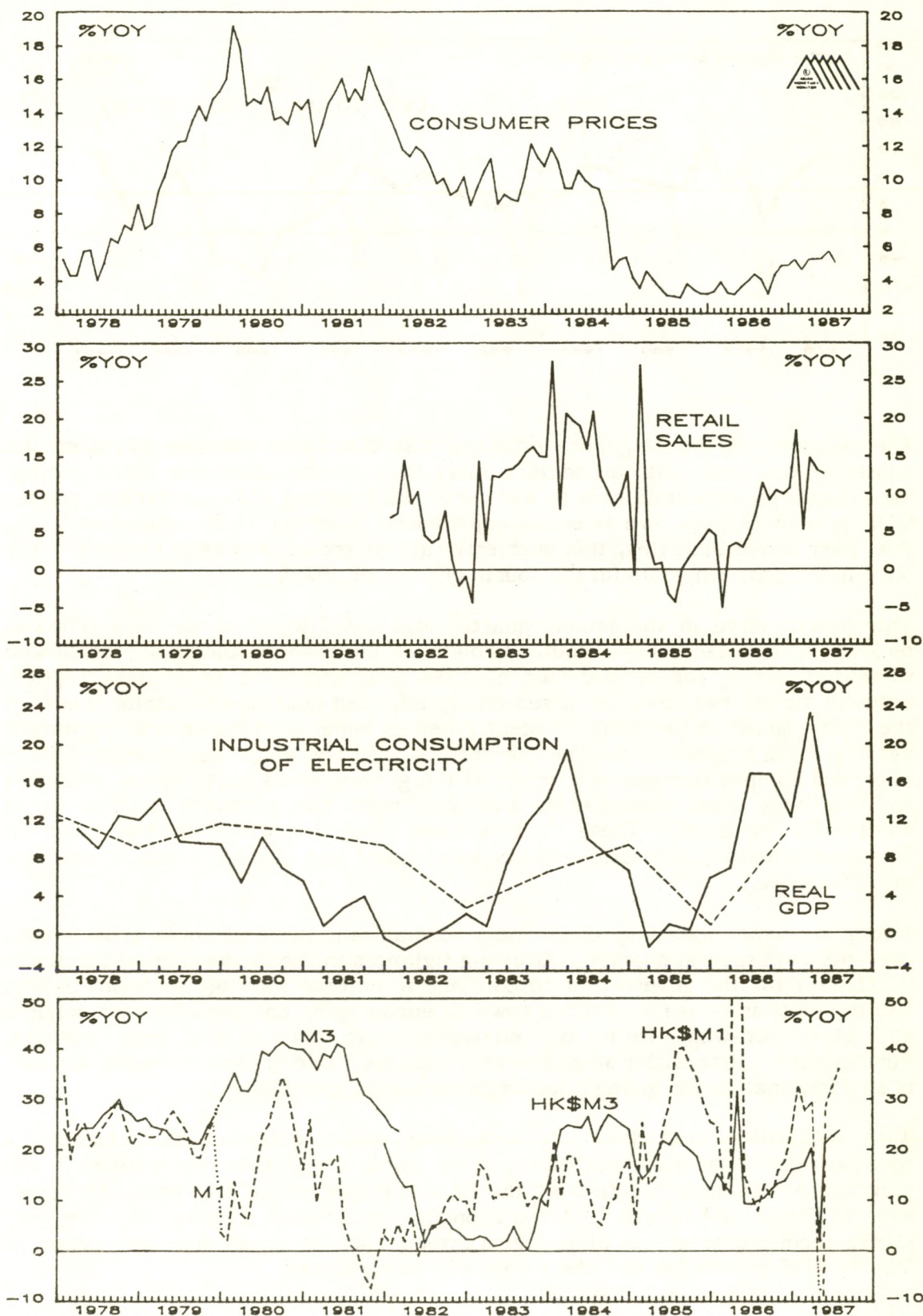


The Hong Kong economy is continuing to grow rapidly on the back of buoyant export growth. For 1986 real GNP growth was recently revised up from preliminary estimates of 8.7% to 11.2%, the best performance since 1979. Although no real GNP numbers are published on a quarterly basis, indications of the economy's strength this year are provided by the 24% year-on-year growth in industrial production during the first quarter, the largest climb since the index was started in 1982, while real domestic export values rose 27% during the first six months of the year compared with 16% for the whole of 1986. Even then this probably understates the extent of the acceleration in the export performance, owing to the increasing location of Hong Kong owned manufacturing units in Guangdong. These exports for the most part would be classified as re-exports, which were up by 49% over the same period.

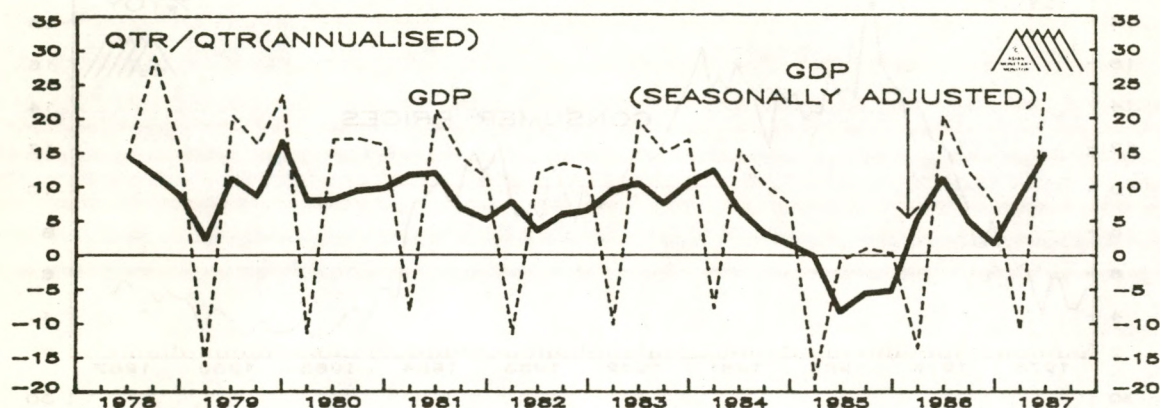
However, pressures on resources are mounting (see Regional Survey). Although inflation, as measured by the consumer price index, dropped below 5% in July the underlying trend is up. During the second quarter prices were 5.4% up on a year earlier, compared with a 4.2% average increase in the first quarter. Interest rates have also risen. Since the beginning of the year the prime lending rate has been raised from 5% to 7.5%. This reflects less on the fact that Hong Kong rates were below US rates, both in real and nominal terms, than to strengthening loan demand, as a response to the buoyant domestic economy in general and the property market in particular.

For the moment the rapid growth in exports is minimising the deterioration on the external accounts resulting from the rising import bill. The trade deficit deteriorated from HK\$4.93 billion in the first half of 1986 to HK\$6.23 billion in the first six months of 1987 as imports rose by 28% over the period. However, the services account is compensating, keeping the current account more or less in balance.

HONG KONG MONEY, OUTPUT, TRADE AND PRICES



SINGAPORE: A BROADENING ECONOMIC EXPANSION



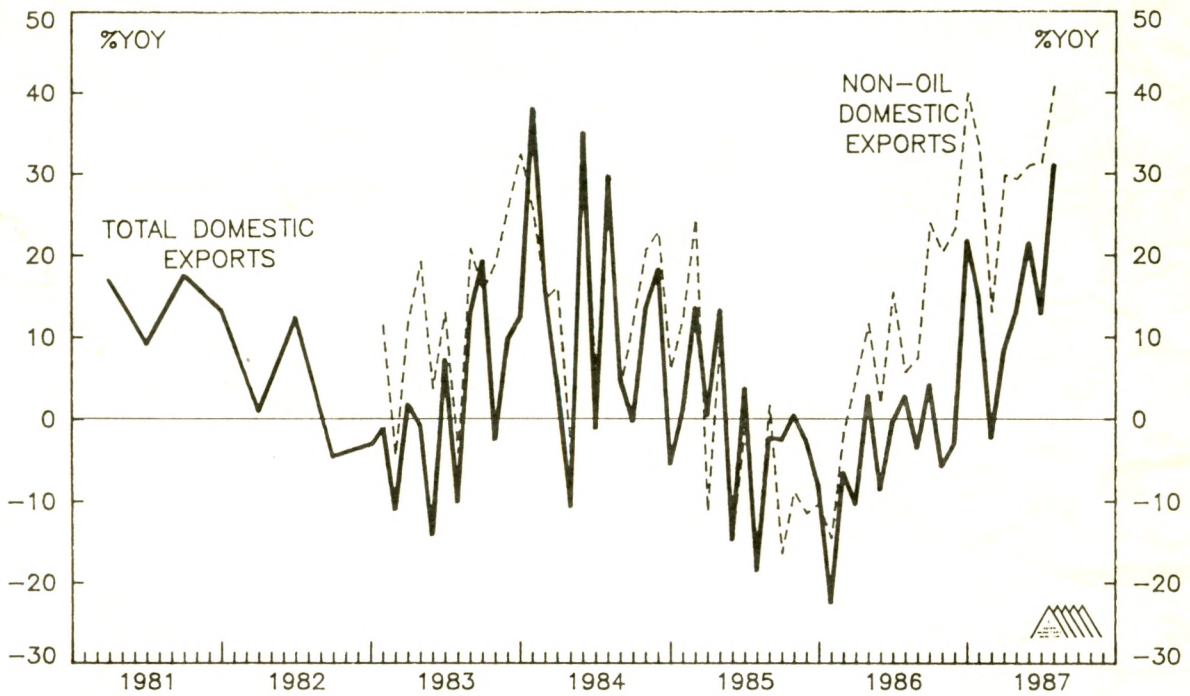
The recovery in the Singapore economy has broadened considerably over the course of this year, with all sectors apart from construction now participating. Second quarter economic growth was particularly strong with quarter-on-quarter GDP growth (AMM's own seasonal adjustment) reaching 14.9% annualised. As the chart above indicates, this quarterly rate of growth has been exceeded only once in the past ten years (in the fourth quarter of 1979).

The growth surge in the second quarter was aided significantly by a renewed pick-up in manufacturing output. Growth of the manufacturing sector slowed somewhat during the second half of 1986 and, according to official figures, actually turned negative, on a seasonally adjusted quarter-on-quarter basis, in the first quarter of this year. Recent renewed impetus to manufacturing output has come particularly from the electronics industry which has benefited from improved competitiveness as a result of the government's cost-cutting measures and exchange rate movements, and also from the recovery in the world electronics industry. These factors have been important in the boom in Singapore's non-oil domestic exports (see chart) and also in direct investment into Singapore.

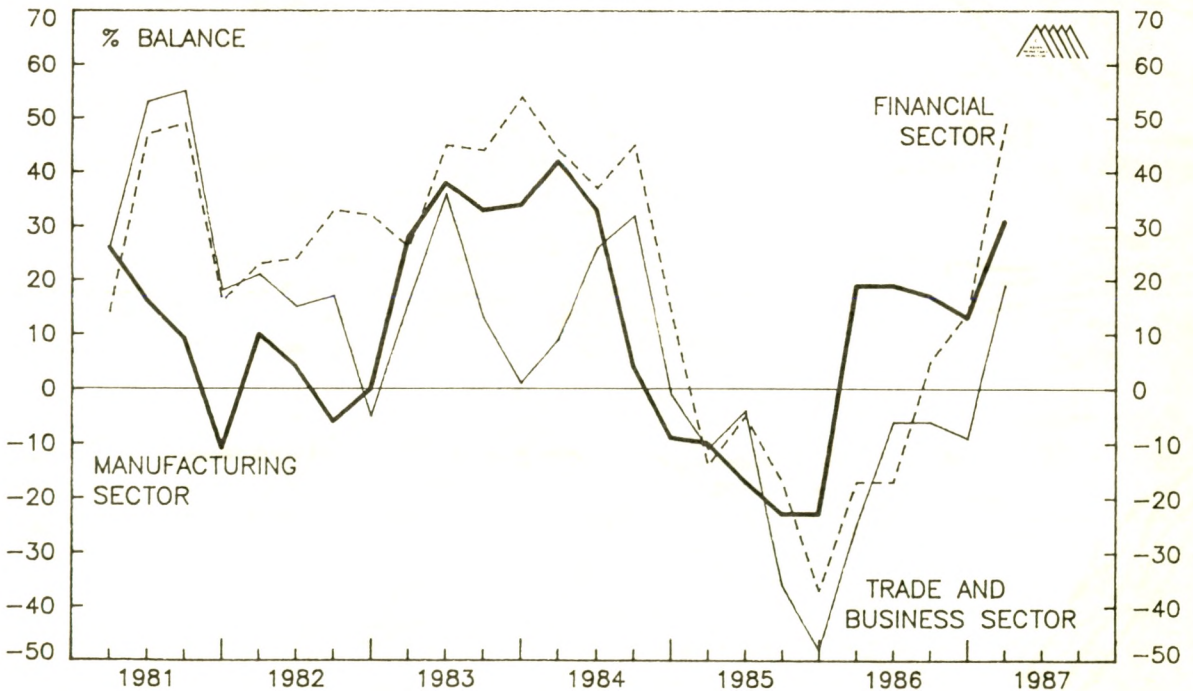
Strong consumer spending should help to maintain the economy's growth rate over the next several quarters. Growing tightness in the labour market has made it difficult for the government to continue to enforce its wage restraint policy, and the emphasis has now shifted towards encouraging companies to use bonuses and other non-wage forms of remuneration to attract and keep workers. Furthermore, along with rising domestic incomes, rapid growth in tourist arrivals is an additional factor giving impetus to consumer spending.

With indications that the only remaining weak sector of the economy - construction - has now bottomed, it is most likely that the economy will maintain a high growth rate over the final two quarters of this year. However, even in the unlikely event that the economy decelerates significantly, the very strong second quarter has almost guaranteed that the consensus expectation of 7%-8% GDP growth for the whole year will be surpassed.

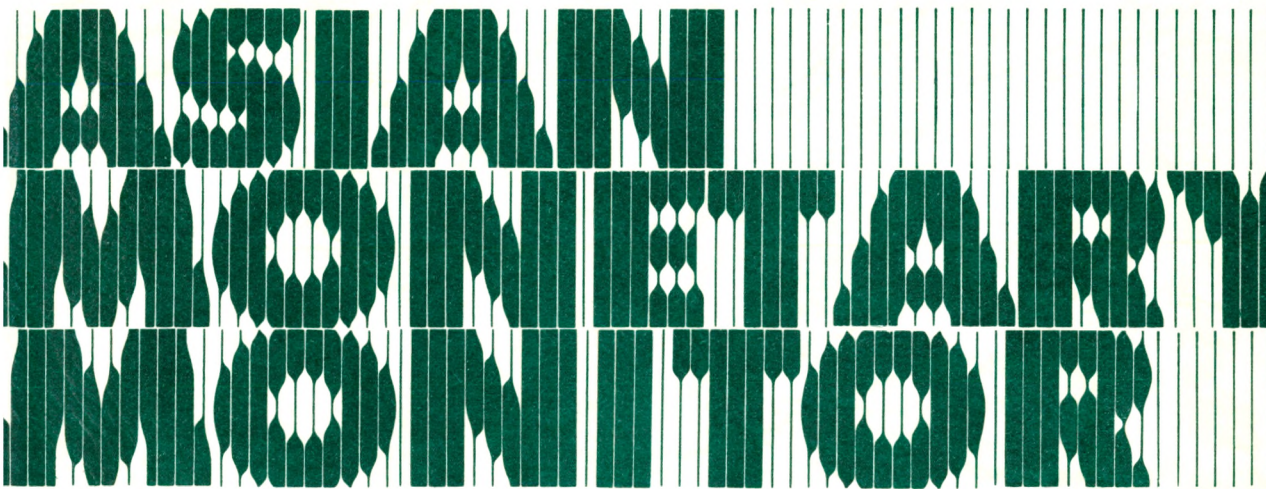
SINGAPORE EXPORTS GROWTH



SINGAPORE BUSINESS EXPECTATIONS (FOR NEXT 6 MONTHS)







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NEW ZEALAND: GROWTH REMAINS SLOW WHILE REFORMS PROCEED

The election of the Labour government in New Zealand in 1984 has led to profound changes in a country which for 30 years had been one of the most highly regulated and slowest growing of the countries along the Pacific Rim. A previous AMM (AMM Vol. 9 No.5, Sept.-Oct. 1985) detailed many of the changes which were effected in the first two years of the new government. This article is an update on those policy changes and the performance of the economy. It also examines the recent high rates of monetary expansion and examines whether these high rates portend future problems for the economy.

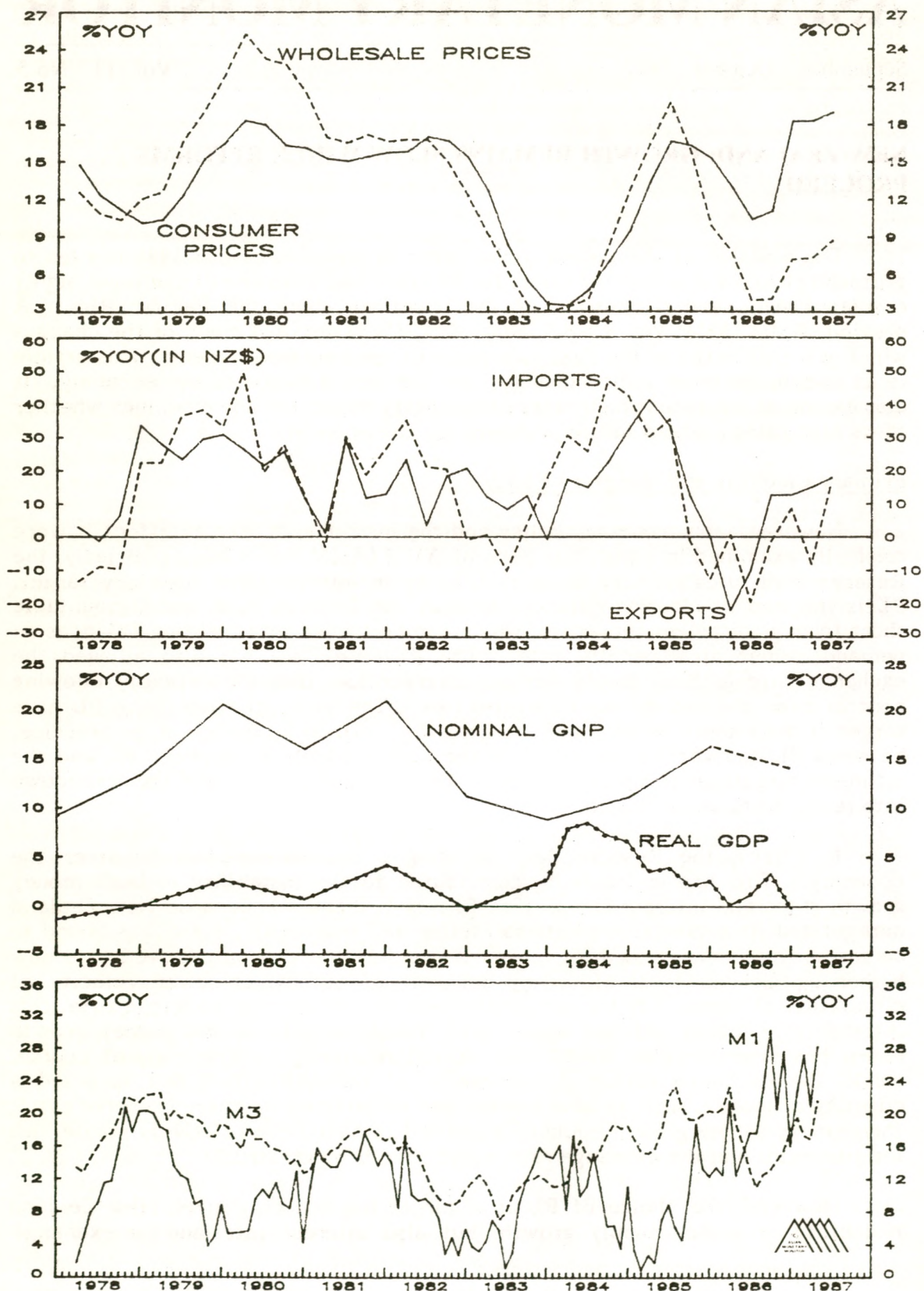
Primary Liquidity and Monetary Policy

New Zealand's monetary policy and the instruments used to effect it were critically examined in a previous issue of AMM (AMM Vol. 9 No. 5). Briefly, the Reserve Bank uses primary liquidity (PL) as an intermediate monetary target. PL is the sum of clearing balances held at the Reserve Bank and discountable short term government securities, which can be turned into clearing balances on demand, albeit at a penalty rate. The Reserve Bank has also allowed the exchange rate to float freely without intervention, thus theoretically allowing control over the money supply aggregates. The problem with using PL as a target is that there is no stable relationship, either in theory or in practice, between PL and various measures of the money supply or between PL and the ultimate targets of monetary policy - nominal GNP growth and its breakdown into real growth and inflation.

In effect, the Reserve Bank is using a defective rudder to steer the economy. This has undoubtedly contributed to the instability in both money growth rates and interest rates. (See Charts 1, 2 and 3.) Because New Zealand deregulated its financial markets so rapidly and thoroughly, there was bound to be instability in the growth of money demand as the economy moved to a new higher equilibrium level of money per unit of output, or lower velocity of circulation of money. If the authorities had been fixing the exchange rate, this instability in money demand would have translated into erratic money growth rates, but interest rates would have stayed relatively constant as, of course, would the exchange rate. Alternatively, if the authorities had targeted a quantity of money, such as base money, and maintained a required reserve ratio, then money supply growth could be expected to have been relatively stable, but interest rates and the exchange rate would have been erratic.

However, the choice of PL as a target has not only given New Zealand instability in money supply growth, but also interest rates and the exchange

NEW ZEALAND: CHART 1 MONEY, OUTPUT, TRADE AND PRICES



rate. The argument put in favour of the use of PL instead of a money target is that an effective base money target would require banks to maintain required reserves. These reserves would in turn cause the banks to undergo costs which are not borne by non-bank financial institutions who would then create money substitutes. The effectiveness of monetary policy would therefore be reduced, causing resources to be wasted in the attempt to evade the reserve requirement. The argument is correct as far as it goes, although the Reserve Bank could lessen the costs of holding required reserves by making the reserve requirement a small fraction and paying near market rates on the reserves in order to lessen the advantage of money substitutes.

The arguments against a fixed exchange rate are less persuasive. While New Zealand's past experiences with a fixed exchange rate were unsatisfactory this reflected more on the fact that the the government did not obey the rules of a successful fixed exchange rate regime rather than on any theoretical shortcomings. Budget deficits were too large and financed partly through printing money. The authorities deliberately maintained an overvalued exchange rate as long as possible while internal inflation was greater than external. Eventually, the pressures to devalue were irresistible. The cost to the economy of this sequence of events was that the private sector made investment and spending decisions based on the wrong signals about the true value of foreign exchange.

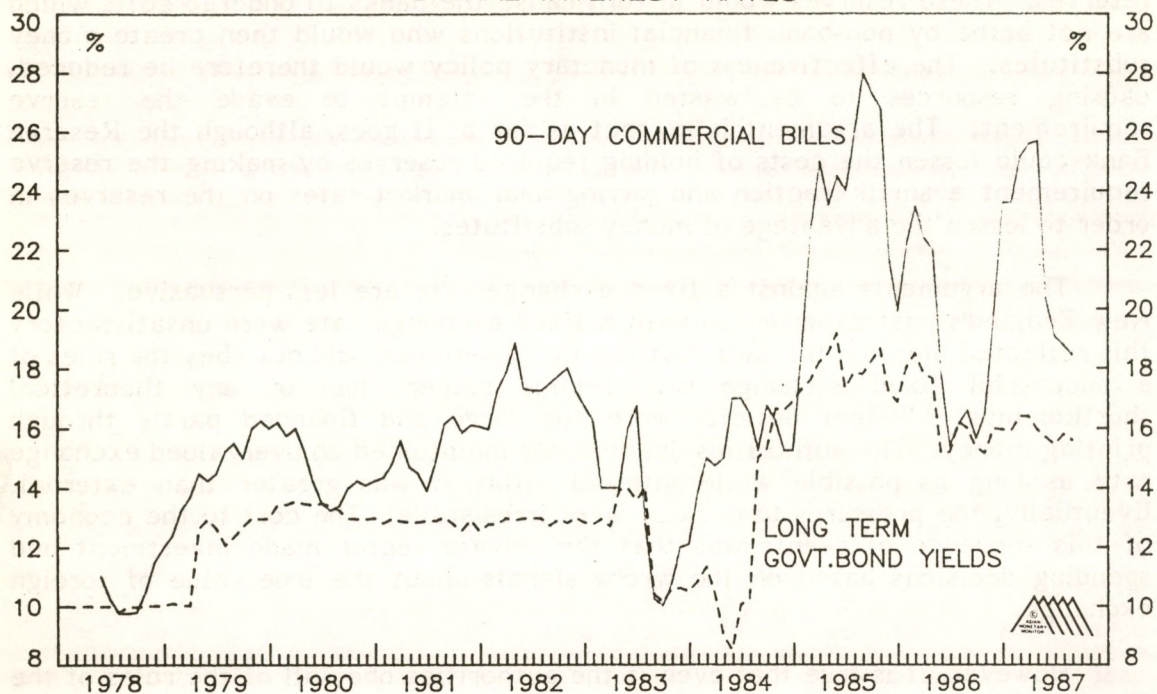
However, it is true that even if the authorities obey all of the rules of the fixed exchange rate regime, New Zealand is still subject to large changes in its terms of trade (see Chart 5) due to the preponderance of agricultural and primary products in exports. Large moves in the terms of trade cause less disruption to the economy if the nominal exchange rate moves in order to smooth the economy's adjustment without the need for the price level in general to change. In the case of an adverse terms of trade change, this allows the real exchange rate to adjust to the country's new conditions without the need for a domestic deflation. Another, less substantive, argument against a fixed bilateral exchange rate is that it would not take account of different currency movements among New Zealand's major trading partners.

However, New Zealand's budget is now nearly balanced. Furthermore, the Treasury does not go directly to the Reserve Bank for borrowings but has to finance its budget through public tenders. And both the terms of trade argument and the question of to which country's currency to fix the exchange rate implicitly assume that a suitable index does not exist. New Zealand could fix its currency to a trade weighted index of foreign currencies. In addition, the authorities could adjust this index to take account of the effects which changes in the terms of trade have in the past had on the real exchange rate. Suffice to say that it is not clear that PL's advantages of being precisely defined and a target which the Reserve Bank can act upon directly outweigh its disadvantages.

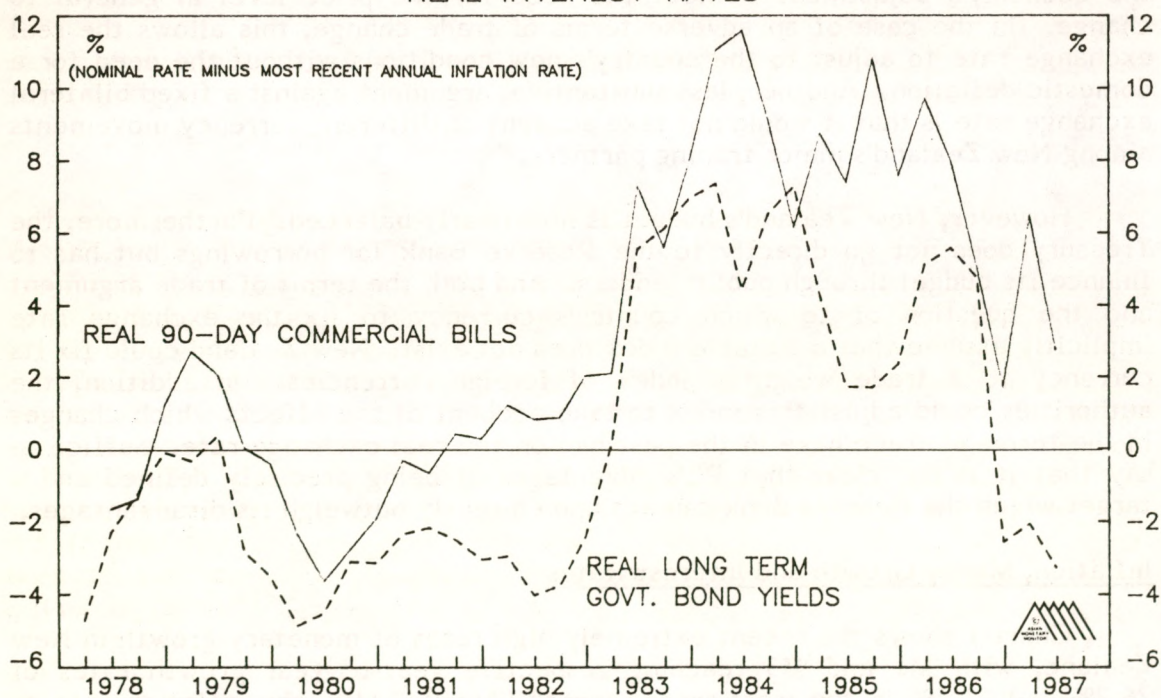
Inflation, Money Growth and Interest Rates

Chart 1 shows the recent extremely high rates of monetary growth in New Zealand, with M1 and M3 reaching respective year-on-year growth rates of 26.2% and 21.5% in the most recent month (April). Also, the inflation rate as measured by the Consumer Price Index (CPI) has risen to frighteningly high

NEW ZEALAND: CHART 2
NOMINAL INTEREST RATES



NEW ZEALAND: CHART 3
REAL INTEREST RATES



levels. Combined with the fact that New Zealand's currency has shown great strength recently, this has resulted in an over-valued real exchange rate. (See Charts 4 and 5.) The Reserve Bank has been responding to both the high CPI and money growth rates by maintaining stringent PL control. In fact, PL has been kept constant in nominal terms. This has contributed to extremely high nominal and real interest rates. (See Charts 2 and 3.) However, the underlying inflation rate is probably lower than suggested on the charts. The Goods and Services Tax (GST), a general sales tax levied at a 10% rate, which was introduced in October 1986 can explain a large part of the high inflation rate. The one time effect on the price level has probably now worked fully through the system. The elimination of the GST effect, the monetary stringency, and the lack of economic growth have led most observers to forecast a much lower 6%-8% inflation rate for calendar year 1988.

According to an unsophisticated monetarist approach, the high level of money growth would imply that this forecast is over optimistic. More fundamentally, few monetarists would characterize a monetary policy which has seen growth rates of M3 as high as 24% as very stringent. However, in the post-1984 period New Zealand has seen very major changes to its financial system. Before 1984, there were controls on the interest rates banks could charge for loans, on the rate they could pay to depositors, and on the type of borrower who had access to funds. This led to a proliferation of non-bank institutions which arose to take over the functions which the banks themselves were not permitted to perform. With the removal of controls, and the paying of market interest rates on all deposits, the demand for money has grown rapidly.

An international comparison of different countries may serve to illustrate how undeveloped New Zealand's financial markets were at the time of deregulation in 1984. The sample includes those six countries which had per capita GNP's closest to New Zealand's in 1984.

Country	Year	GNP/Capita (US\$)	M2/GNP
Trinidad and Tobago	1982	6020	42.1%
Hong Kong	1984	6230	71.8%
Italy	1984	6520	76.3%
New Zealand	1984	7010	29.1%
Singapore	1984	7420	68.1%
Belgium	1984	8280	45.4%
United Kingdom	1984	8460	41.6%

Source: International Monetary Fund and World Development Report

In 1984, New Zealand's over-regulated financial system was clearly not as large as would be predicted by its level of economic development. Hence the rapid growth in money which has been seen since 1984 has not been as inflationary as expected because it has been added to money balances, which had previously been kept artificially low by the heavy regulation of the financial system. At the end of this process of monetization of the economy, New Zealand could well have a money supply which is double its 1984 size when measured relative to GNP.

If this version of events is correct, and the Reserve Bank has been responding to the large increases in the money supply with monetary stringency, then they have been unwittingly slowing the re-monetization of the economy, possibly contributing to the high level of real interest rates shown on Charts 2 and 3. A counter argument, however, is that the Reserve Bank is incapable of setting the real interest rate in a country which has perfectly free capital movement. All restrictions on capital movements were effectively removed in 1984. This argument explains the high level of rates as being caused by New Zealand's large and growing external debt (see Chart 6). Foreign loans are the marginal source of funds for New Zealand and foreigners must be compensated for both the risk of default and the high risk of devaluation. The strength, and probable over-valuation, of the New Zealand dollar is shown in Chart 5.

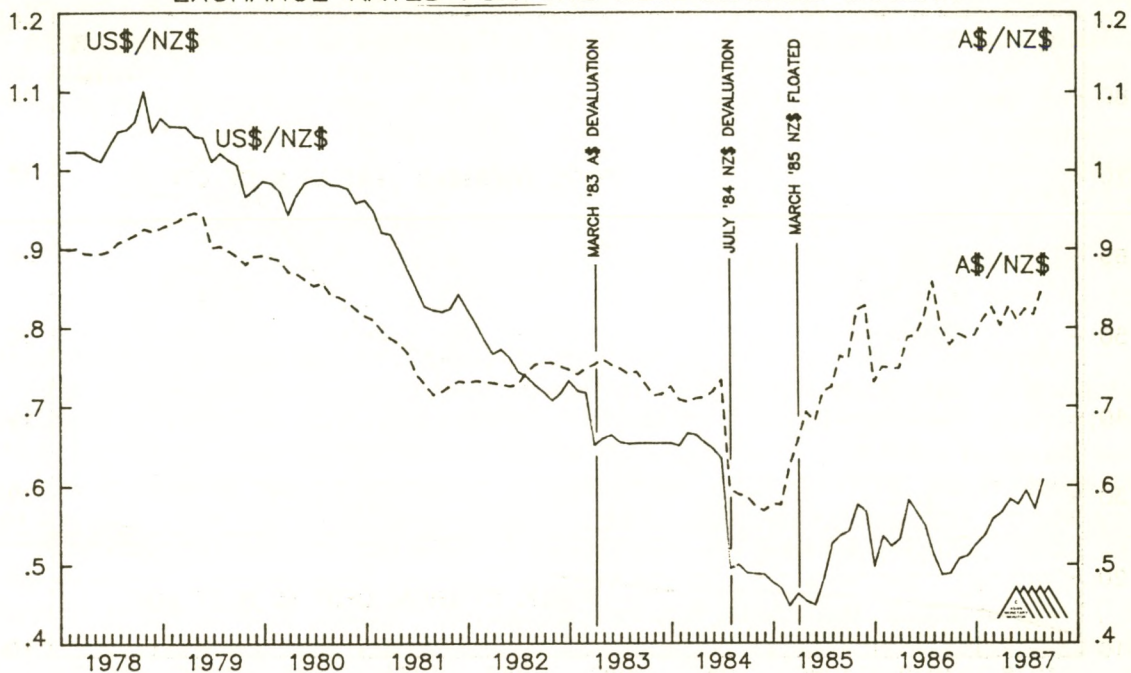
Another factor which is undoubtedly adding to the demand for funds in New Zealand is the large portfolio adjustments which are occurring. Previously, consumers were not allowed to borrow, as they are now, in order to finance purchases of consumer durables. Consumers are not as sensitive to the level of interest rates on consumer purchases as businesses are when evaluating investment decisions. Also, the introduction of the GST in October 1986 led to consumers bringing forward their purchases in order to avoid the tax.

Given all of the above factors, the question remains as to whether real interest rates have been held above an equilibrium level by the Reserve Bank's policy. Clearly, in the long run, with no restrictions on capital movement, the monetary authority can not raise real interest rates above equilibrium. This is true no matter what monetary target or Central Bank operating procedures are used. (This abstracts from the second-order effects which an erratic monetary policy can have on long-term equilibrium interest rates.)

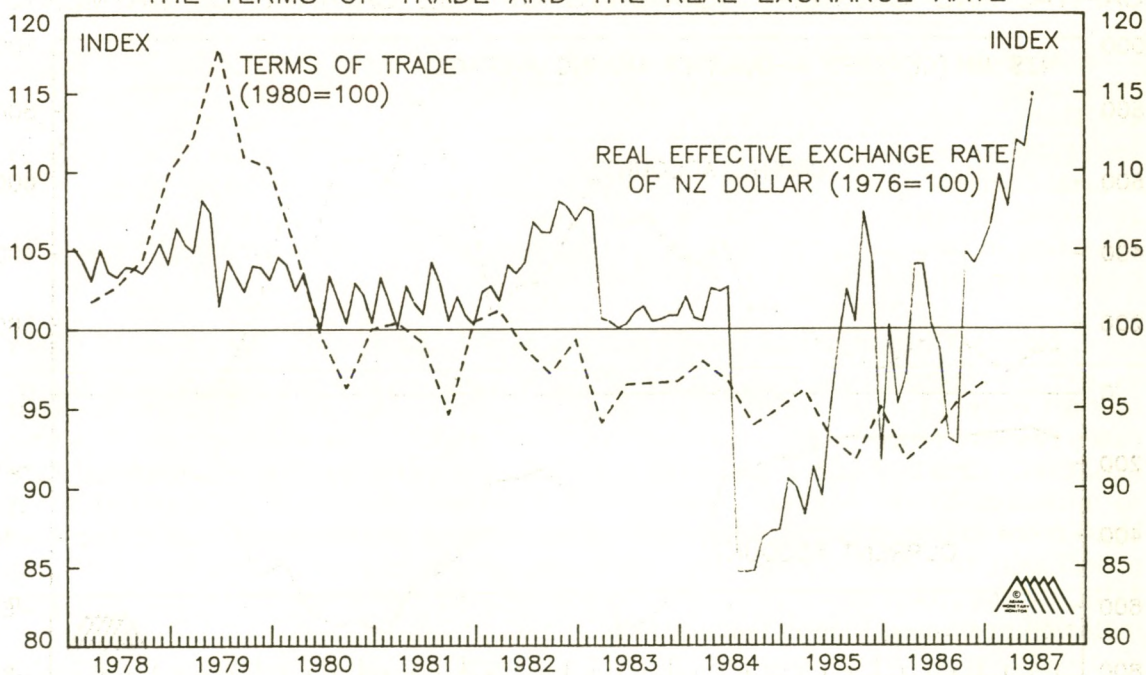
It is also the case that New Zealand has undergone tremendous changes in its economic policy and financial system. The impact of these changes on real variables is hard to quantify. It might be reasonable to expect that, given the uncertainty surrounding the eventual results of the policy reforms, the supply of capital to New Zealand would not be perfectly elastic at a constant differential to world interest rates that takes account of the various risks inherent in investing in New Zealand. If that is true, then Reserve Bank stringency could be contributing to the high level of real interest rates in New Zealand.

Nominal interest rates will probably fall in the future. As shown in Chart 2, the short-term rate has been above the long-term rate, implying that the market expects a fall. But in addition, it appears that New Zealand's interest rates respond more to past realized rates of inflation than to forecasts of future inflation. Charts 2 and 3 looked at together illustrate that the real interest rate as measured by the nominal interest rate minus preceding one year inflation has been more stable than nominal rates alone. This is an indication (not an ironclad proof) that the market does have the postulated behaviour. If in fact inflation falls to the forecast levels, and interest rates therefore have too large an inflation premium, then rates will fall.

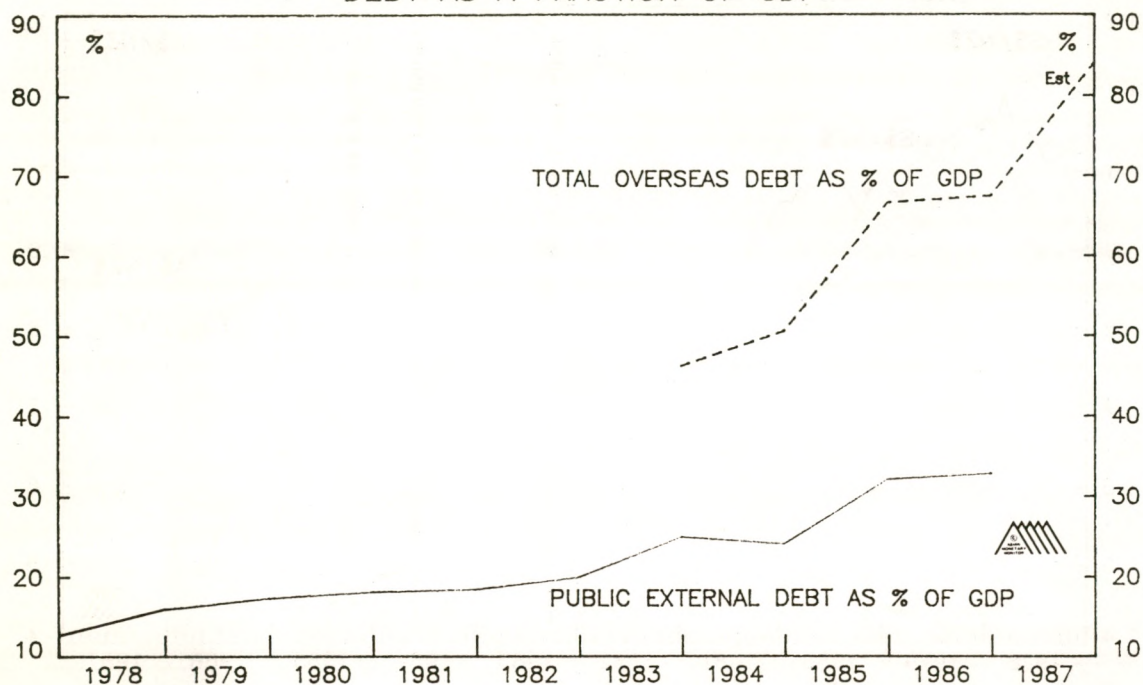
NEW ZEALAND: CHART 4
EXCHANGE RATES FOR THE NEW ZEALAND DOLLAR



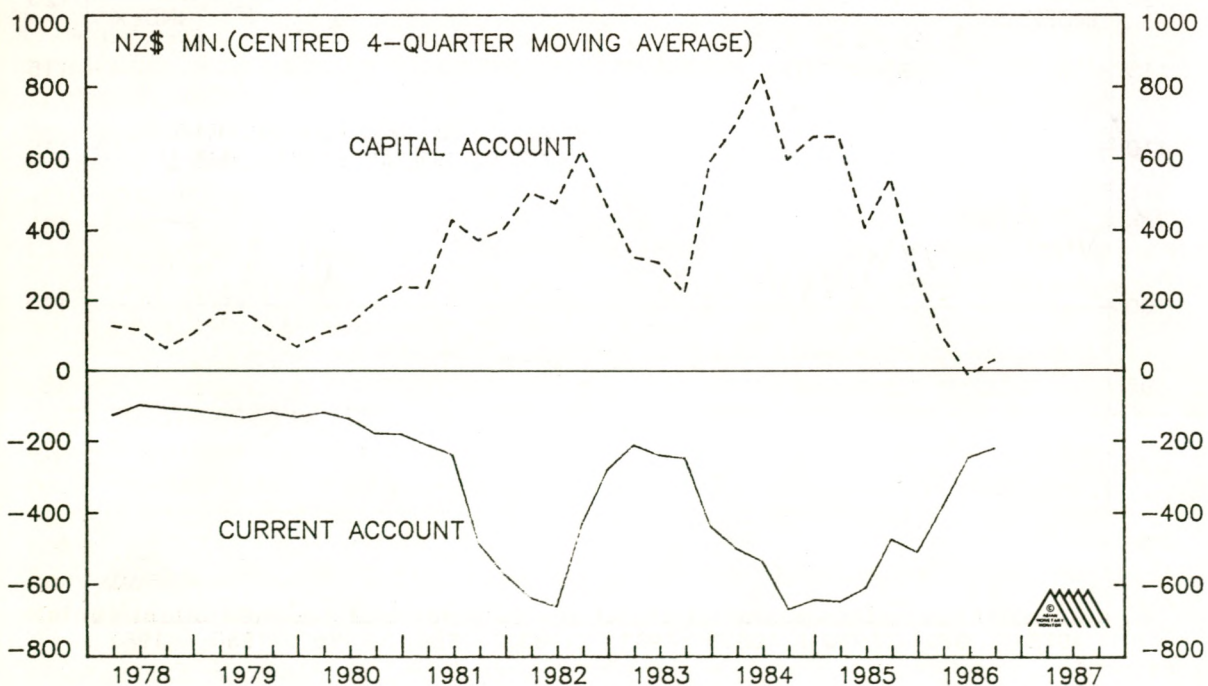
NEW ZEALAND: CHART 5
THE TERMS OF TRADE AND THE REAL EXCHANGE RATE



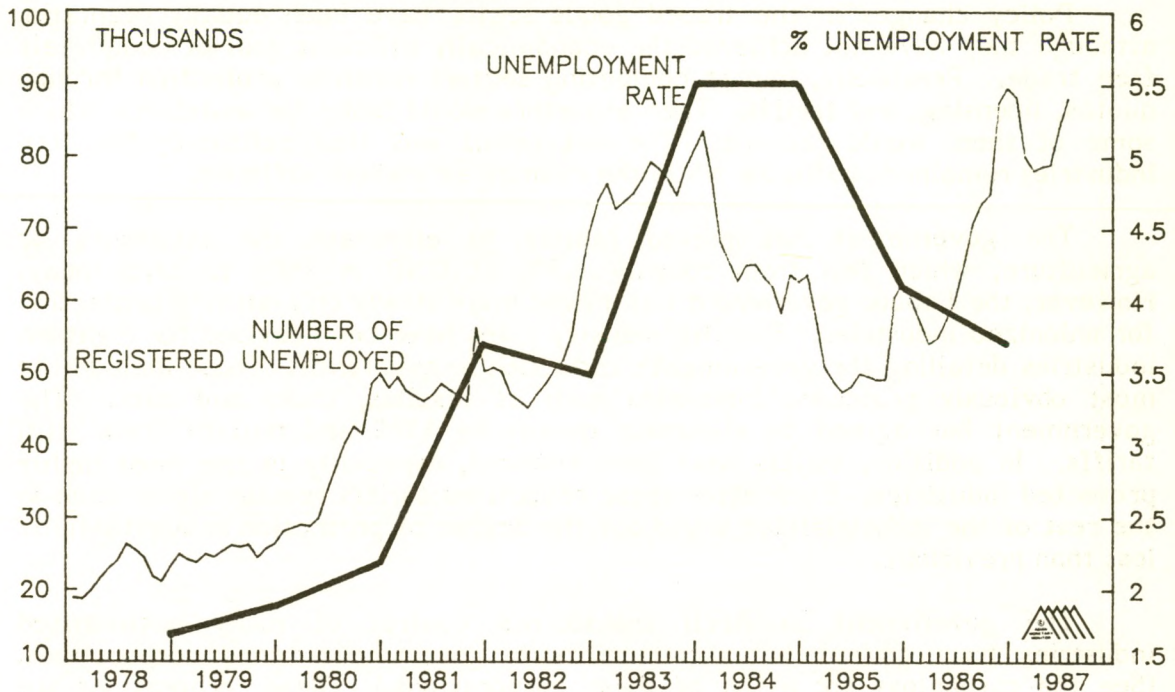
NEW ZEALAND: CHART 6
DEBT AS A FRACTION OF GDP



NEW ZEALAND: CHART 7
CAPITAL AND CURRENT ACCOUNTS OF THE BALANCE OF PAYMENTS



NEW ZEALAND: CHART 8
UNEMPLOYMENT RATE



Taxes, Trade, Spending, and the State-Owned Enterprises

The reforms of the Labour government have not been confined to the financial sector. They have touched upon nearly all aspects of the government. In October 1986, the GST replaced a variety of excise and sales taxes which had been levied at widely divergent rates, with a general tax of 10%. This reform is likely to lead to a better allocation of resources than previously. Also, since the tax is placed on many goods which were formerly exempt and is collected like a European-style Value Added Tax, many people are reporting income for the first time. Thus, an additional gain from the new system has been an increase in the personal income tax collections. With government accounts kept at the Reserve Bank rather than in the commercial banking sector, unexpectedly large payments in the March quarter drained reserves from the banking system and led to the large run-up in interest rates at the beginning of the year.

At the same time the income tax schedule was also greatly revised. The revision reduced the number of brackets and, most importantly, lowered the top marginal tax rate. Prior to the reform a family or person earning more than NZ\$38,000 per year paid a 66% marginal tax rate. After the reform, the highest marginal tax rate was reduced to 48% for incomes above NZ\$30,000. This means that the after-tax remuneration on marginal work effort for a person in the top marginal bracket has been increased by 53%. This huge increase in after-tax remuneration for additional effort represents a major incentive to greater work effort. The effect of both the sales tax reform and the income tax reform should be to increase the level of GNP relative to where it would have been. During the transition to this higher level of output the growth rate of GNP

should be higher than it would otherwise have been.

Policy changes in the traded goods sector have been equally dramatic, although they have not achieved the economically efficient goal of completely free trade. Previously, import competing sectors received protection through quotas, licensing, and tariffs. Then exporters would lobby for assistance which some of them would receive. The net result was that politically-favoured industries remained profitable while the country as a whole suffered.

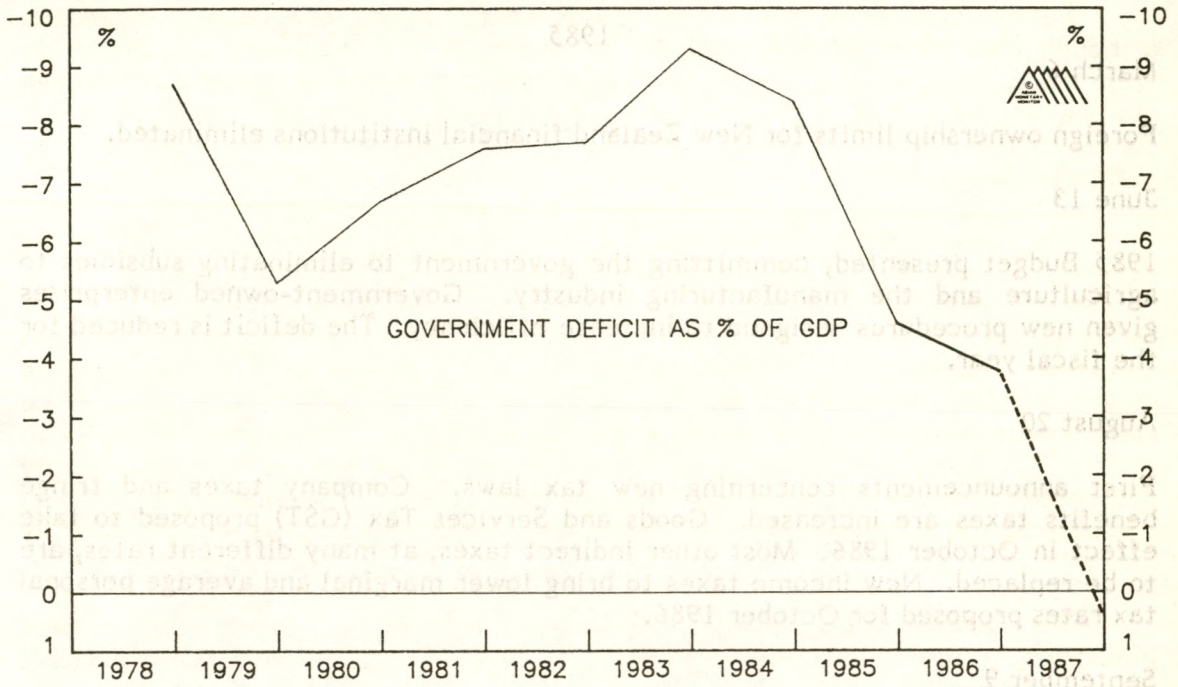
The government has moved rapidly to eliminate the assistance to agriculture, which fell from roughly 4.5% of GNP in 1984 to zero today. However, the Labour government has moved more slowly on removing protection for unionized industries. Specific industry plans have been devised for eighteen industries detailing the government's reduction in assistance. These include the most obviously protected industries such as textiles, shoes and cars. The government has agreed to eliminate quotas by 1988 and replace them with tariffs. In addition, tariffs have been reduced, especially in the most highly protected industries. Even after these reductions tariffs remain higher than in the rest of the industrialized world but the degree of protection is substantially less than previously.

The government in April transferred control of many nationalised industries from government departments to government-owned corporations. (See the chronology for a list of these corporations.) These corporations are from now going to have to act like profit-making companies, paying taxes and dividends. They also have to pay back the government loans they had previously received at favourable rates. If the government requires them to act in a way which they would not do if operating as a profit-maximizing business, the government must subsidize them for their expected losses. The government has also cleaned up the books of the "Think Big Projects" by assuming their debts. These actions of rationalizing the public sector were highlighted by the recent budget which forecast a small surplus for the 1987/88 fiscal year. This is down from a deficit equivalent to 8.4% of GNP in 1984.

FORECAST: New Zealand has undergone a very radical economic policy change in a short time. This is a testimonial both to the extent of the crises which New Zealand faced in 1984 and the determination of Finance Minister Roger Douglas to remedy the situation the Labour Party faced upon taking office. During the transition, certain sectors of the economy which had been artificially supported, such as agriculture, will have to shrink while other sectors previously repressed by regulation such as financial services (see Chart 10) are certain to grow rapidly. While these sectoral adjustments are taking place economic growth may be quite slow, with vast differences in the relative performance across sectors. Thus, the forecasts of 0-2% growth for next year, while low, are likely to pave the way for a much higher secular rate of economic growth at a later stage. Given the state of economic morass in 1984 and the length of time for which previous economic policies had been followed, it seems likely that New Zealand has an income far below that which its physical and human resources would indicate possible. It would not be surprising if New Zealand were able to enter a period of rapid and prolonged growth, say at a 5% rate, in the not too distant future.

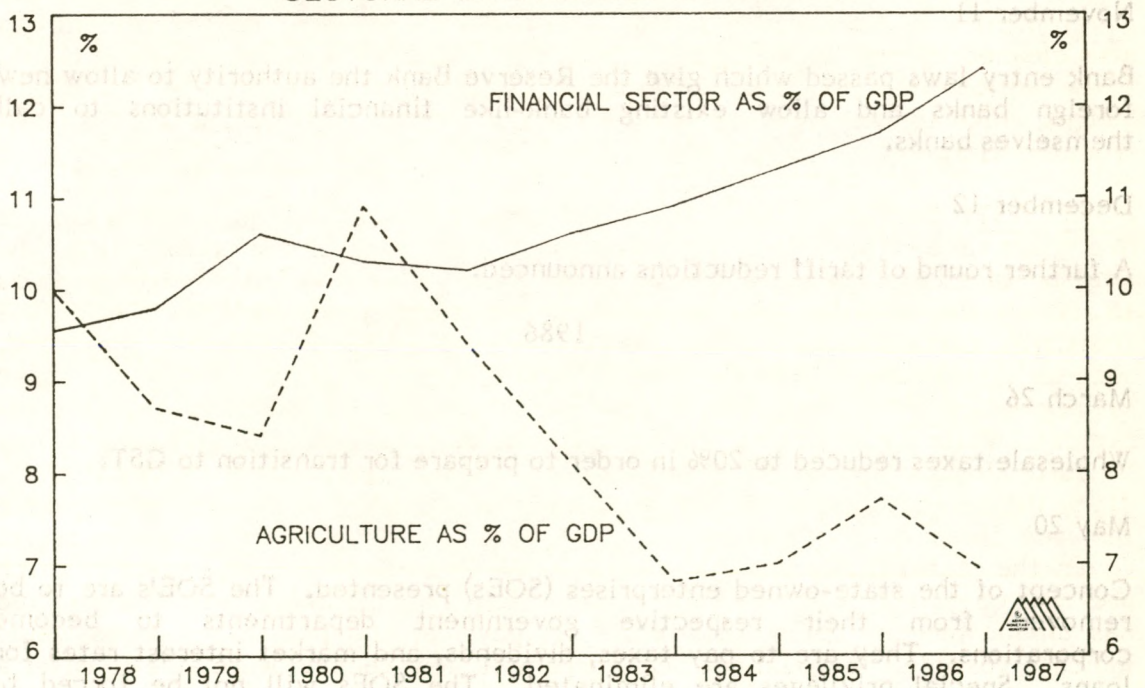
NEW ZEALAND: CHART 9

THE GOVERNMENT DEFICIT



NEW ZEALAND: CHART 10

SECTORAL DIVERGENCES IN GROWTH



CHRONOLOGY OF MAJOR ECONOMIC POLICY EVENTS IN NEW ZEALAND (MARCH 1985 TO SEPTEMBER 1987)

1985

March 6

Foreign ownership limits for New Zealand financial institutions eliminated.

June 13

1985 Budget presented, committing the government to eliminating subsidies to agriculture and the manufacturing industry. Government-owned enterprises given new procedures designed to increase efficiency. The deficit is reduced for the fiscal year.

August 20

First announcements concerning new tax laws. Company taxes and fringe benefits taxes are increased. Goods and Services Tax (GST) proposed to take effect in October 1986. Most other indirect taxes, at many different rates, are to be replaced. New income taxes to bring lower marginal and average personal tax rates proposed for October 1986.

September 9

New plans to reduce protectionism announced. Tariffs to be reduced and import licensing to be gradually eliminated.

November 11

Bank entry laws passed which give the Reserve Bank the authority to allow new foreign banks and allow existing bank-like financial institutions to call themselves banks.

December 12

A further round of tariff reductions announced.

1986

March 26

Wholesale taxes reduced to 20% in order to prepare for transition to GST.

May 20

Concept of the state-owned enterprises (SOEs) presented. The SOE's are to be removed from their respective government departments to become corporations. They are to pay taxes, dividends, and market interest rates for loans. Special privileges are eliminated. The SOEs will not be forced to undertake activities at a loss without an explicit subsidy from the government.

July 17

Reserve Bank given power to allow domestic parties which meet certain specified requirements to set up banks. Reserve Bank given the responsibility for prudential supervision of the banks.

July 31

The 1986 budget is presented. It confirms that the government is going ahead with the GST and income tax cuts, as planned. The government assumes debt of NZ\$7.2 billion from the "Think Big" projects as well as various producer board debts.

October 1

New tax law goes into effect. GST begins and income tax rates are lowered.

1987

April 1

The State Owned Enterprises begin operation. They are the Electricity Corp., the Forestry Corp., the Land Corp., Telecom, New Zealand Post, the Airways Corp., the Coal Corp., and Government Property Services.

June 18

The 1987/88 budget is announced, with a planned surplus in the government accounts achieved through the sale of government assets.

July

New banking licenses granted to eight, mostly foreign, banks.

August 15

Labour re-elected with 56 seats in the Parliament compared with 41 seats for the National party. The popular vote was 47.4% for Labour and 44.6% for the National Party, with the balance going to minor parties.

Sources include OECD Survey of New Zealand, May 1987.

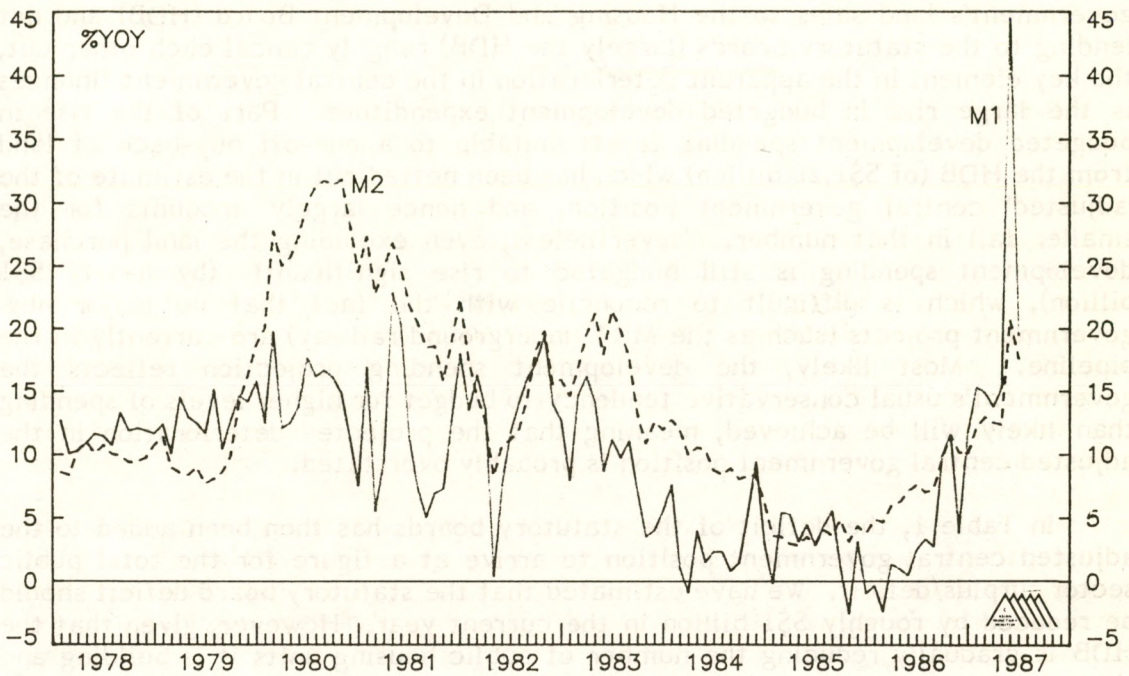
SINGAPORE: THE PUBLIC SECTOR IS NO LONGER A SOURCE OF MONETARY STIMULUS

After a brief period of relatively stable monetary growth (between October 1986 and April 1987) over the most recent months Singapore's monetary aggregates have shown a renewed acceleration. However, although the recent surge in money supply growth (see Chart 1) essentially continues the trend of easing liquidity in place since late 1985, the source of monetary expansion has shifted. In terms of an analysis of the components of the monetary base the period of rising monetary growth since November 1985 can be roughly separated into two sub-periods. Between November 1985 and October 1986 easing liquidity conditions can be seen as the monetary consequence of a major easing in government fiscal policy (see AMM Vol. 9 No. 5). Since April this year, however, rising monetary base growth can be explained more by the influence of the overall balance of payments, specifically a reduction in net capital outflows from the banking sector consequent upon improving loan demand in Singapore (see AMM Vol. 10 No. 6). In the current fiscal year (which began in April) the government's tax and spending policy is no longer a source of further stimulus to the economy while the public sector in the broadest sense may have already shifted back to being a somewhat contractionary element in liquidity trends, particularly when the potential drain on liquidity resulting from government bond issues and the privatisation programme is taken into account.

Over the past two years the quality of published data on public finance has been significantly improved to give a clearer picture of the overall fiscal stance. The coverage of the government's budget, announced in the March preceding each fiscal year (April to March) has also been expanded to give a more accurate picture of the finances of the central government in that it now includes central government receipts (e.g. from land sales), and repayments of loans, from the statutory boards. Previously, the budget included central government lending to the statutory boards but not funds received from them (see AMM Vol. 9 No. 2). Historic data for revenue and expenditure of the public sector as a whole (separated into central government and statutory boards) is available on a calendar year basis in the Ministry of Trade and Industry's annual 'Economic Survey'. It is possible to very roughly reconcile the government budget numbers with the 'Economic Survey' data (notwithstanding the fact that the former is on a fiscal year, and the latter on a calendar year, basis) and hence arrive at an estimate for overall public sector finance in the current calendar year. In Table 1 this has been done by first netting out from the budget all items which represent flows of funds between the government and other public sector bodies and then adding back in the deficit of the statutory boards (which is available, exclusive of transactions with the central government, in the 'Economic Survey', and which we have 'guesstimated' for 1987).

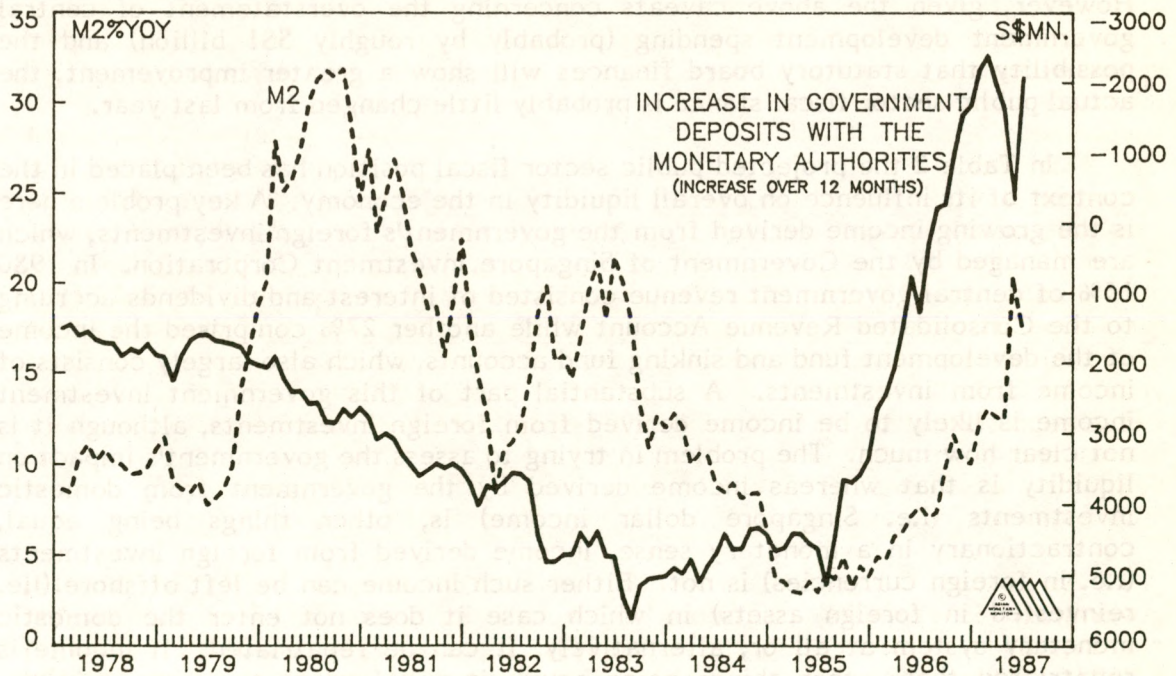
As Table 1 indicates, on the announced budget basis the central government is expected to record an overall deficit of S\$3.75 billion in the current fiscal year, deteriorating sharply from a S\$516 million surplus in FY1986. When flows of funds between the government, statutory boards and the Central Provident Fund (CPF) are netted out the 'adjusted' central government

SINGAPORE: CHART 1
MONEY SUPPLY



SINGAPORE: CHART 2

THE IMPACT OF THE PUBLIC SECTOR'S OPERATIONS UPON MONEY GROWTH



position shows a somewhat smaller deterioration, from an estimated surplus of S\$2.53 billion to a small deficit of S\$129 million. Because the fund transfers between the government, statutory boards and the CPF as well as the government's land sales to the Housing and Development Board (HDB) and net lending to the statutory boards (largely the HDB) roughly cancel each other out, the key element in the apparent deterioration in the central government finances is the large rise in budgeted development expenditure. Part of the rise in budgeted development spending is attributable to a one-off buy-back of land from the HDB (of S\$1.26 billion) which has been netted out in the estimate of the 'adjusted' central government position, and hence largely accounts for the smaller fall in that number. Nevertheless, even excluding the land purchase, development spending is still budgeted to rise significantly (by nearly S\$1 billion), which is difficult to reconcile with the fact that no major new government projects (such as the MRT underground railway) are currently in the pipeline. Most likely, the development spending projection reflects the government's usual conservative tendency to budget for higher levels of spending than likely will be achieved, meaning that the projected deterioration in the adjusted central government position is probably overstated.

In Table 1, the deficit of the statutory boards has then been added to the adjusted central government position to arrive at a figure for the total public sector surplus/deficit. We have estimated that the statutory board deficit should be reduced by roughly S\$1 billion in the current year. However, given that the HDB is gradually reducing the number of public housing units it is building and that the strong economy should markedly increase the revenues of statutory boards such as the Port of Singapore Authority, Telecoms and the Public Utilities Board, this estimate might prove conservative. The total public sector is then estimated to show a small deficit for the current year, of just over S\$600 million, representing a deterioration of roughly S\$1.5 billion from FY1986. However, given the above caveats concerning the overstatement of central government development spending (probably by roughly S\$1 billion) and the possibility that statutory board finances will show a greater improvement, the actual public sector fiscal stance is probably little changed from last year.

In Table 2 the projected public sector fiscal position has been placed in the context of its influence on overall liquidity in the economy. A key problem here is the growing income derived from the government's foreign investments, which are managed by the Government of Singapore Investment Corporation. In 1986 15% of central government revenue consisted of interest and dividends accruing to the Consolidated Revenue Account while another 27% comprised the income of the development fund and sinking fund accounts, which also largely consists of income from investments. A substantial part of this government investment income is likely to be income derived from foreign investments, although it is not clear how much. The problem in trying to assess the government's impact on liquidity is that whereas income derived by the government from domestic investments (i.e. Singapore dollar income) is, other things being equal, contractionary in a monetary sense, income derived from foreign investments (i.e. in foreign currencies) is not. Either such income can be left offshore (i.e. reinvested in foreign assets) in which case it does not enter the domestic monetary system at all or, alternatively, it can be repatriated. If income is repatriated then, other things being equal, it will lead to an increase in the government's deposits in the Singapore banking system and, under the closely

TABLE 1

ADJUSTED GOVERNMENT BUDGETS FOR FY1986-1987

Millions of Singapore Dollars

	FY1986	FY1987
1. Current Revenue	10,135	11,680
2. (transfer from statutory boards)	-	1,500
3. Adjusted Current Revenue (1-2)	10,135	10,180
4. Recurrent Expenditure	6,389	8,974
5. (interest payment to CPF)	-	1,450
6. Adjusted Current Spending (4-5)	6,389	7,524
7. Capital Receipts	6,703	3,243
8. (land sales to HDB)	4,605	1,743
9. Adjusted Capital Receipts (7-8)	2,098	1,500
10. Development Expenditure	4,791	7,025
11. (grants, land purchases, from statutory boards)	1,480 est.	2,740 est.
12. Adjusted Development Spending (10-11)	3,311 est.	4,285 est.
13. Net Lending to Statutory Boards	5,141	2,671
14. ANNOUNCED BUDGET POSITION (1-4+7-10-13)	+516	-3747
15. ADJUSTED (CENTRAL) GOVT. POSITION (3-6+9-12)	+2,533 est.	-129 est.
16. STATUTORY BOARDS DEFICIT (Calendar Year Basis)	-1,605	-500 est.
17. PUBLIC SECTOR 'FISCAL' POSITION (15+16)	928 est.	-629 est.

TABLE 2

PUBLIC SECTOR MONETARY IMPACT

Millions of Singapore Dollars

	Calendar Year		
	1985	1986	1987 (est.)
Public Sector Surplus	1,659	1,432	-629
Net Inflow into the CPF	2,634	954	300
Increase in Other Domestic Debt	1,498	820	2,200
<u>Less Foreign Investment Income (est.)</u>	<u>2,500</u>	<u>2,260</u>	<u>2,400</u>
= Increase in Public Sector Deposits	3,291	946	-530
Increase in Govt. Deposits at MAS	3,350	-1,685	
Increase in Govt. Deposits at Banks	253	666	
= Increase in Public Sector Deposits	3,604	-1,019	

managed exchange rate regime, an increase in the Monetary Authority of Singapore's (MAS) foreign assets (because the government will sell the foreign currency for domestic currency). In neither case will the monetary base or money supply be affected. Essentially, therefore, in trying to reconcile government finance data with the monetary data there are two unknowns with respect to government foreign income; firstly, how much of government revenue comprises income from foreign investments, and secondly, how much, if any, of the foreign income is actually repatriated. Only the first of these unknowns is relevant when considering the effect of the government's budget on the actual money supply, however.

In Table 2 we have made an adjustment for government foreign investment income on the assumptions that all foreign income accruing to the government is included in the budget but that none of the income is actually repatriated (i.e. it is all re-invested in foreign assets). The historic estimate for government foreign income given in the table is itself the average of two different estimates, each derived from the foreign reserves and balance of payments data, checked against the available government finance statistics. The first method used was simply to take the year average of the monthly figures for official foreign reserves and assume that the reserves earn interest at the rate for US three month treasury bills. This approach yields an estimate of S\$1,859 million for government foreign income in 1985, and S\$1,658 million for 1986. The second method was to derive an estimate from the investment income account and capital accounts of the balance of payments. The private sector deficit on investment income was estimated by calculating the cumulative net foreign investment in Singapore since 1960 and making the assumptions that the cumulative net non-monetary foreign investment (i.e. largely direct investment) yields a (dividend) return of 4% while the cumulative net monetary capital investment yields a return at the three month treasury bill rate. The surplus for government investment income was then taken as the sum of the overall investment income surplus for the country (from the balance of payments) and the estimated investment income deficit for the private sector (Total investment income surplus = government investment income surplus - private sector investment income deficit). This second approach gives an estimate for government foreign investment income of S\$3,140 million in 1985 and S\$2,865 million in 1986. The figures given in Table 2 for the investment income adjustment then represent the average of the estimates from the two methods for the respective years. Although possibly appearing to be based on somewhat arbitrary assumptions, these estimates for government foreign income are roughly compatible with the available government finance statistics, and suggest that between 40% and a half of the central government's income from investments derives from foreign investments.

From Table 2 it can be seen that the public sector surplus (the number used in this table being that given in the 'Economic Survey', on a calendar year basis) minus the foreign investment income component, when taken together with the proceeds from sales of government debt to the Central Provident Fund (equivalent to the CPF net inflow) and the financial institutions suggest that public sector deposits in the banking system should have risen by close to S\$950 million in 1986, down from nearly S\$3.3 billion in 1985. Monetary data published by the MAS, however, imply that public sector deposits in the banking system were actually drawn down last year, falling by over S\$1 billion. Although there

is clearly significant room for error in the calculation of the increase in public sector deposits, particularly in the estimation of the foreign investment income component of the government fiscal surplus, it is not clear where this discrepancy arises.

In the current year (and from now on) it is more difficult to forecast the influence of the government's operations upon trends in liquidity. This is because the government, in May, began regular auctions of government bonds with a view to establishing a Singapore government securities market in order to enhance the development of Singapore's capital market. Previously the government only issued debt to the CPF and financial institutions for the purposes of their statutory requirements and there was no secondary market in government debt. Issues to the new government bond market are under the management of the MAS, which plans to issue S\$35 billion (gross) of Treasury bills (of 91-day, 182-day and 364-day maturity) and two and five year government bonds over the next five years. As at the end of August S\$1.1 billion of two and five year bonds had been issued (S\$500 million of five year bonds and S\$300 million of two year bonds in May, and S\$300 million of five year bonds in August) auctions of these instruments being held on a quarterly basis. Auctions of 91-day Treasury bills are held weekly and 182-day bills are auctioned on a fortnightly basis.

Clearly, a large proportion of the S\$35 billion worth of government debt the MAS plans to issue over the next five years will represent replacement of maturing Treasury bills. From a monetary perspective the important number is the net issue, or the increase in the total outstanding amount, of debt. For example, one hypothetical profile for debt issue could involve the MAS issuing, on average, S\$50 million of 91-day Treasury bills each week, S\$50 million of 182-day Treasury bills every fortnight and S\$300 million each of 364-day Treasury bills, and two and five year bonds every quarter. It can be simply calculated that this profile of debt issue would result in a total issue of securities of S\$37.5 billion over five years, but would leave only S\$10.9 billion outstanding at the end of the five year period (the remainder having matured within the five years). The increase in outstanding debt over the five year period would then break down into a net issue of S\$4.9 billion in the first year, S\$2.4 billion in the second year, and S\$1.2 billion in each of the final three years, illustrating that this simple type of profile would satisfy the MAS' wish to achieve the bulk of the increase in the outstanding amount of government securities in the early part of the five year period.

Of course, from a monetary perspective the important question is how the government will use the funds raised from the issue of securities. In response to investors' concerns on this issue the MAS has said that funds raised through bond auctions will be 'recycled'. This implies that the funds raised will be deposited in the domestic banking system, in the framework of Table 2 coming under the 'increase in government deposits at banks'. If this is the case, then as the funds would not leave the domestic banking system, there would be no negative impact on the monetary base, or drain on bank liquidity. (In Table 2, only the increase in deposits at the MAS has a negative impact on the monetary base, and hence constitutes a drain on liquidity.)

In the Table, Treasury bills have been excluded from the 1987 estimate of the increase in other domestic debt because of their short maturity and their

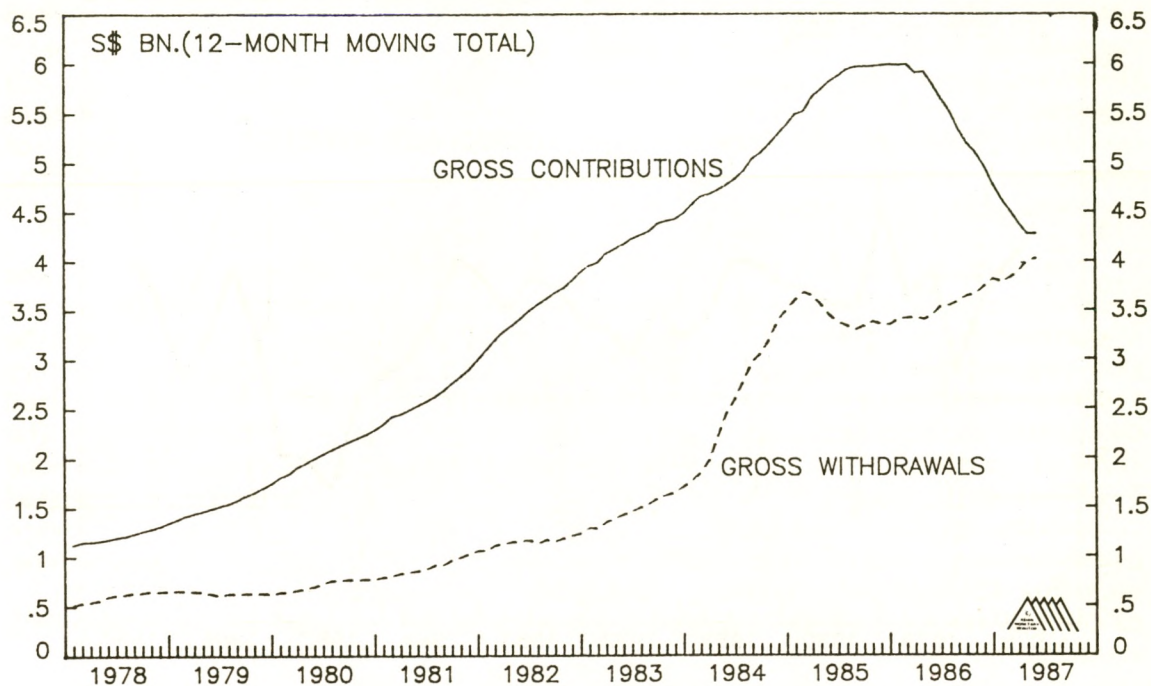
primary use by the banking system as a tool of liquidity management. Thus the figure of S\$2.2 billion given in the table reflects the expected issue of two and five year government bonds in the current calendar year. When taken together with the other components of the change in public sector deposits, this then suggests a small drawdown of public sector deposits in the current year. However, given the probable over-estimate of the size of the budget deficit referred to earlier, the more likely final outcome might be a small increase, as last year. This could still be compatible with another drawdown of public sector deposits at the MAS given the monetary authority's intention to 'recycle' the proceeds of the government bond issues.

A second potentially important element in the liquidity picture is the programme of privatisation of government-linked companies. The Public Sector Divestment Committee, in its report released in February, recommended the sale of government-held shares in 41 companies. Of these 41 companies, 15 were recommended for listing on the stockmarket while another 8 already listed companies were recommended for a reduction in government shareholdings. The value of government shares in these companies to be divested is placed at around S\$2.9 billion (on a shareholders' funds basis). In addition, a further 15 unlisted companies with government shareholdings valued at S\$106 million were recommended for divestment through means other than public share floatations, including 12 total privatisations. The committee also considered the possibility of the privatisation of four statutory boards, which if undertaken would involve a significantly larger sale of shares.

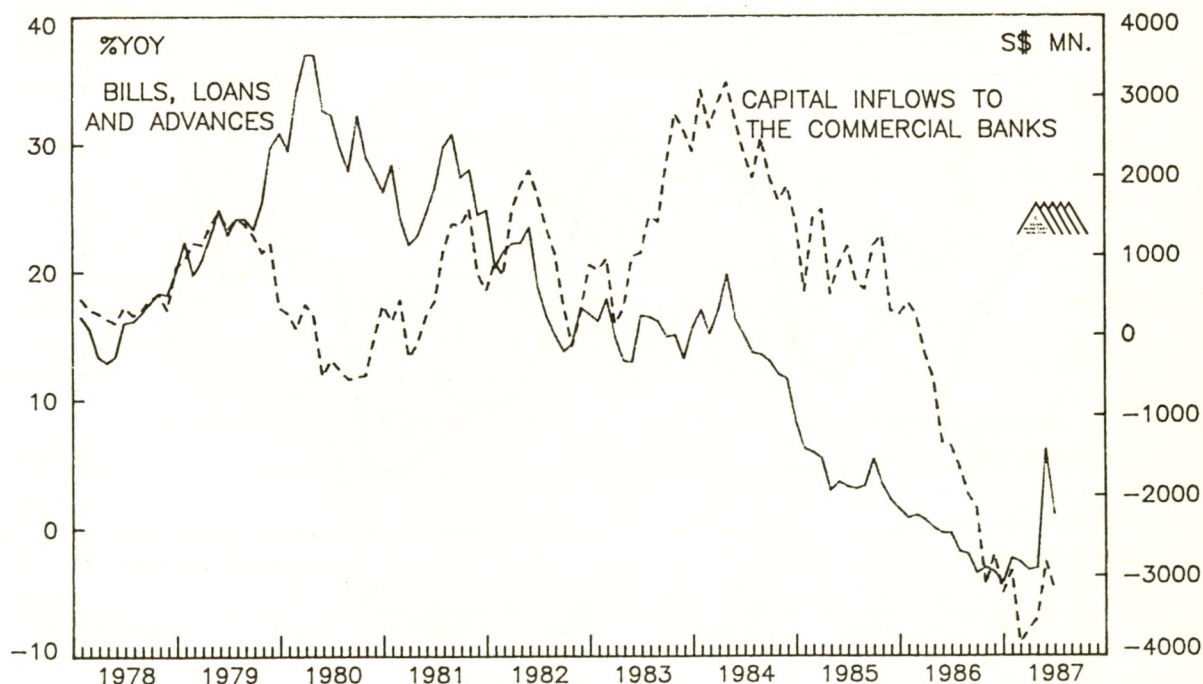
In the current year, sales of shares in government-linked companies previously held by the government or other government-linked companies totals S\$1.22 billion. Five companies have been newly listed (Resources Development Corporation, Singapore National Printers, Sembawang Maritime, Jurong Shipyard, DBS Land) while three have had reductions in government shareholdings (Sembawang Shipyard, Singapore Airlines, Neptune Orient Lines). However, of the S\$1.22 billion, only S\$810 million flows directly to the government (or specifically largely the government holding company Temasek Holdings), the remainder representing sales of shares previously held by other government-linked companies. This amount could theoretically represent a drain on liquidity from the economy if it becomes a deposit at the MAS, although it is not clear that this should be considered separately from the government's budget. Theoretically, whether the proceeds of share sales by Temasek are fully incorporated within the budget or whether Temasek pays to the government a special dividend which is then budgeted for, any withdrawal of funds from the economy as a result of privatisation should already be included in the annual budget, and therefore already accounted for in Table 2.

Nevertheless, more generally, it is clear that the ongoing privatisation programme and government bond issues (as well as government plans to phase in a 5% increase in the total CPF contribution rate beginning from next July), when taken together with the likelihood of a restrained fiscal policy stance, make it increasingly difficult to see the public sector's operations as a source of stimulus to the economy either currently or over the next few years. Against this background, the key factor behind the current surge in monetary growth is the strong pick-up underway in bank lending. The huge jump in lending in May, evident on Chart 4, was associated with the oversubscription to the Sembawang

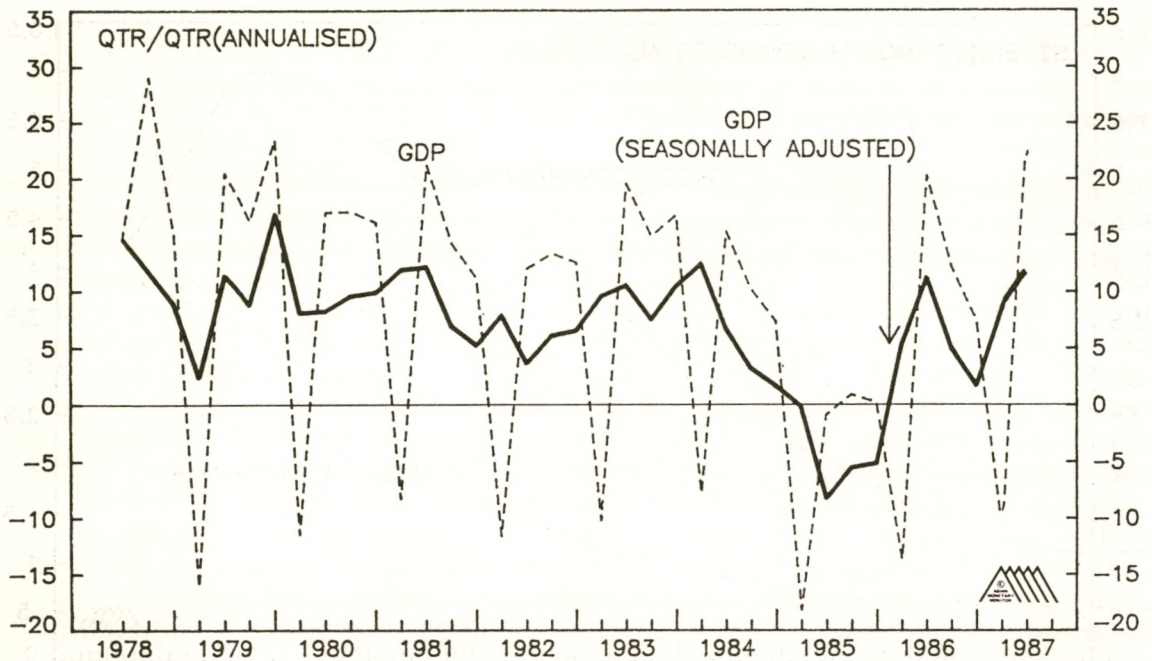
SINGAPORE: CHART 3
CONTRIBUTIONS TO AND WITHDRAWALS FROM THE C.P.F.



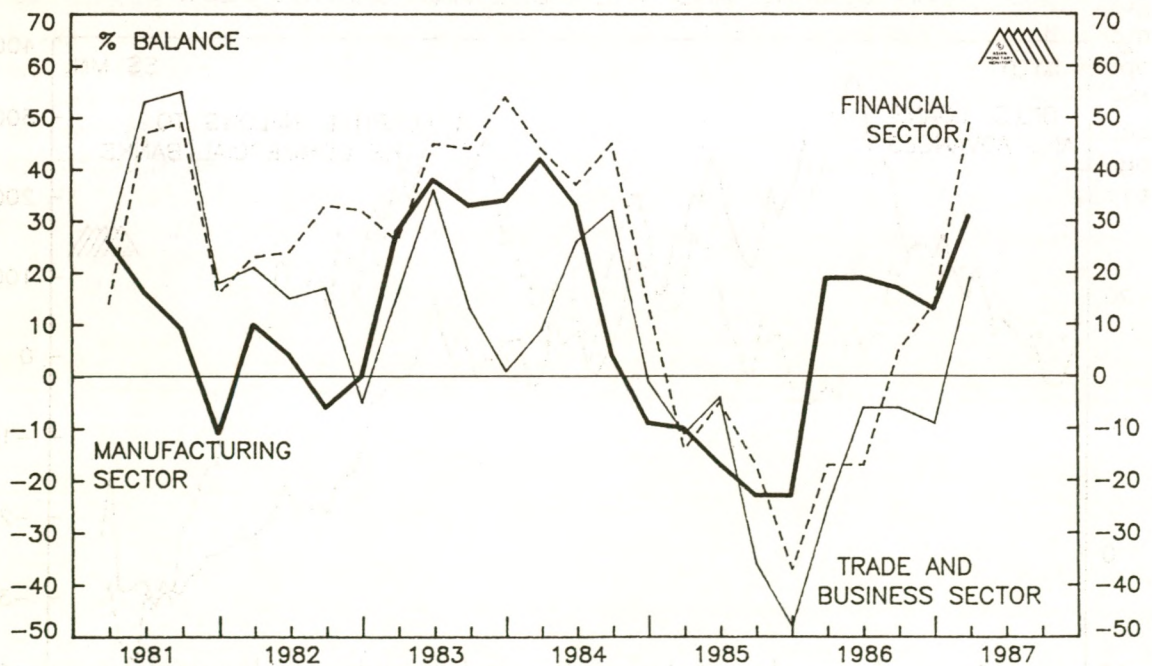
SINGAPORE: CHART 4
LOAN DEMAND AND THE MONETARY CAPITAL FLOW



SINGAPORE: CHART 5
GROSS DOMESTIC PRODUCT



SINGAPORE: CHART 6
BUSINESS EXPECTATIONS (FOR NEXT 6 MONTHS)

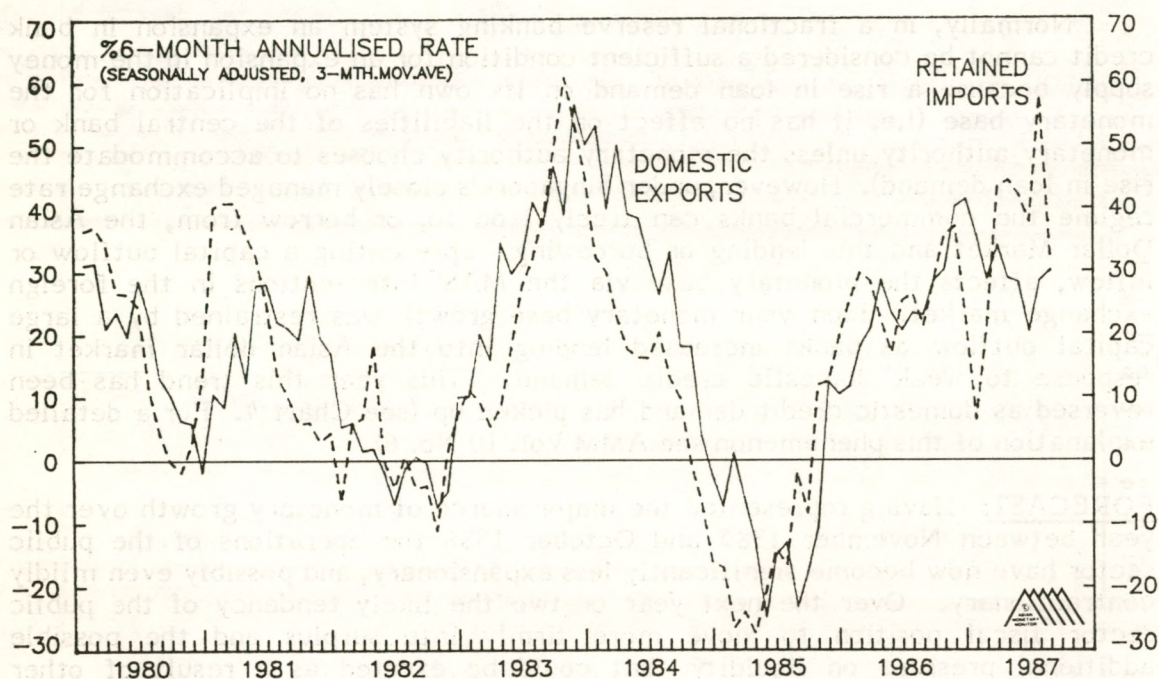


Maritime floatation and was reversed in June. However, underlying bank lending is clearly now rising strongly and should continue to do so as the economy gathers further momentum (see AMM Vol. 11 No. 4).

Normally, in a fractional reserve banking system an expansion in bank credit cannot be considered a sufficient condition for an expansion in the money supply because a rise in loan demand on its own has no implication for the monetary base (i.e. it has no effect on the liabilities of the central bank or monetary authority unless the monetary authority chooses to accommodate the rise in loan demand). However, under Singapore's closely managed exchange rate regime the commercial banks can freely lend to, or borrow from, the Asian Dollar Market and this lending or borrowing, representing a capital outflow or inflow, affects the monetary base via the MAS' interventions in the foreign exchange market. Last year monetary base growth was restrained by a large capital outflow as banks increased lending into the Asian dollar market in response to weak domestic credit demand. This year this trend has been reversed as domestic credit demand has picked up (see Chart 4. For a detailed explanation of this phenomenon see AMM Vol. 10 No. 6).

FORECAST: Having represented the major source of monetary growth over the year between November 1985 and October 1986 the operations of the public sector have now become significantly less expansionary, and possibly even mildly contractionary. Over the next year or two the likely tendency of the public sector fiscal position to move more firmly into surplus and the possible additional pressure on liquidity that could be exerted as a result of other government operations (government bond issues, privatisation, CPF policy) make it increasingly difficult to see public sector operations as a source of monetary stimulus. In the longer term, however, the existence of a secondary market in government bonds opens up the possibility that the MAS will be able to exercise more discretionary control over the monetary aggregates (through open market operations in government bonds), particularly if they allow more flexibility in the the Singapore dollar/US dollar exchange rate. In the short term, an improving balance of payments position owing largely to a sharp reduction in capital outflows from the banking system, should ensure that monetary growth continues to rise.

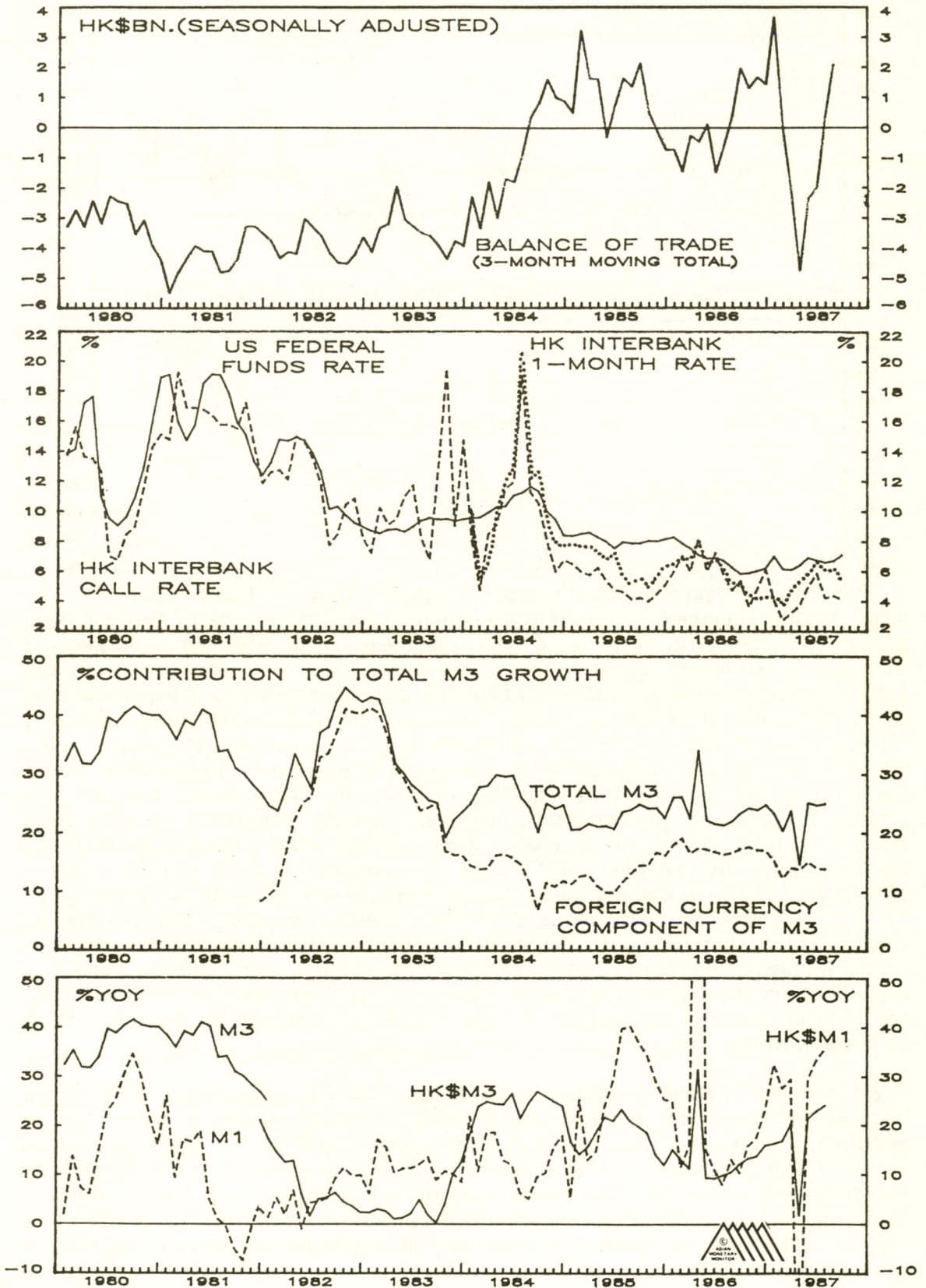
HONG KONG: TRADE ACCOUNT DETERIORATION WILL PRESAGE TIGHTER LIQUIDITY



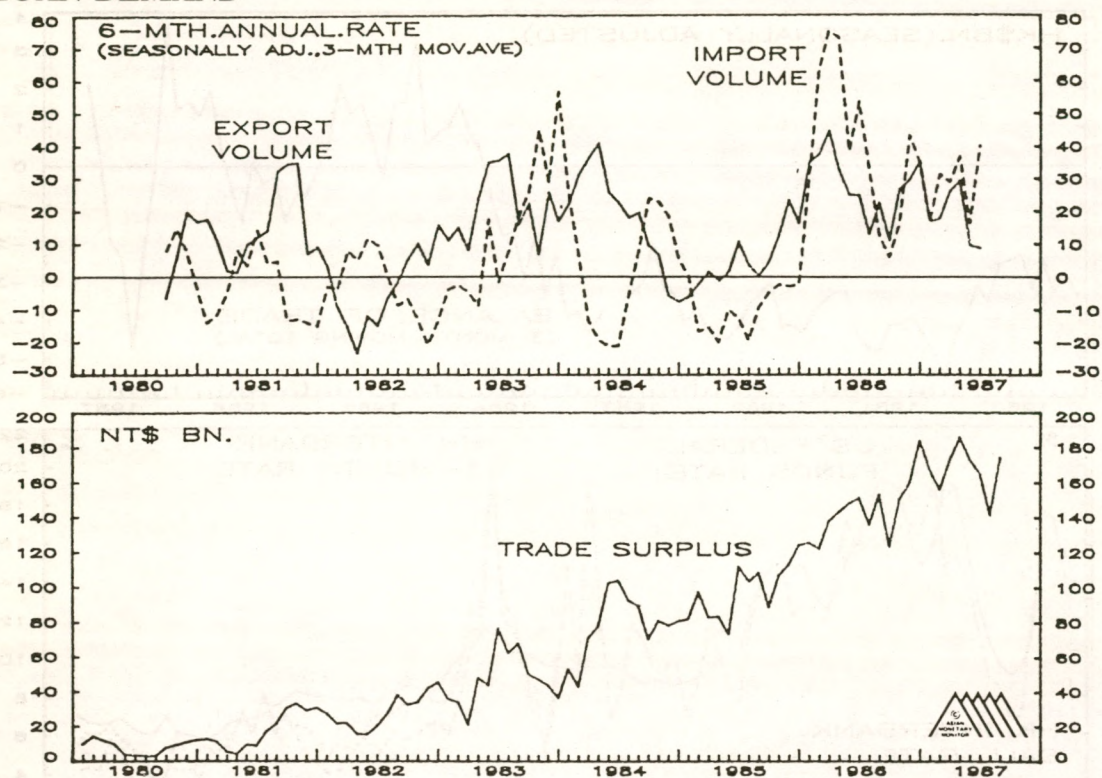
Money supply growth in Hong Kong has remained in an uptrend since July 1986 with the year-on-year growth rate for HK\$M3 rising to 24.1% in the most recent month (July). Under Hong Kong's linked exchange rate system the ability of the commercial banks to expand their balance sheets is effectively tied to Hong Kong's overall balance of payments, because the note-issuing banks are required to pay over US dollars to the government's exchange fund in order to issue new currency. Although complete balance of payments data are not available for Hong Kong, it is clear that the territory has had a strong tendency to overall surplus on its external payments at least since 1985. As a result, Hong Kong dollar interest rates have remained fairly consistently below their US dollar counterparts. In the latter part of 1985 it is possible that the strong growth in banks' foreign currency deposits (see chart opposite), implying a growing capital outflow from the banking system, could have played some part in keeping the growth rate of the Hong Kong dollar monetary aggregates subdued.

Since the end of 1985 the driving force in the economy, and in the balance of payments and liquidity trends, has been the export boom which Hong Kong has enjoyed in response to competitive gains. Rapid growth in domestic exports has, until recently, enabled the trade account to remain in surplus. However, this year with economic growth in the order of 15%, the growth of retained imports has begun to far outpace the growth of domestic exports (see chart above). Although for the time being a strong invisibles account should keep Hong Kong's current balance in surplus, under the linked exchange-rate regime 'over-heating' of the economy is ultimately a self-correcting process and therefore liquidity must eventually be expected to tighten.

HONG KONG LIQUIDITY INDICATORS



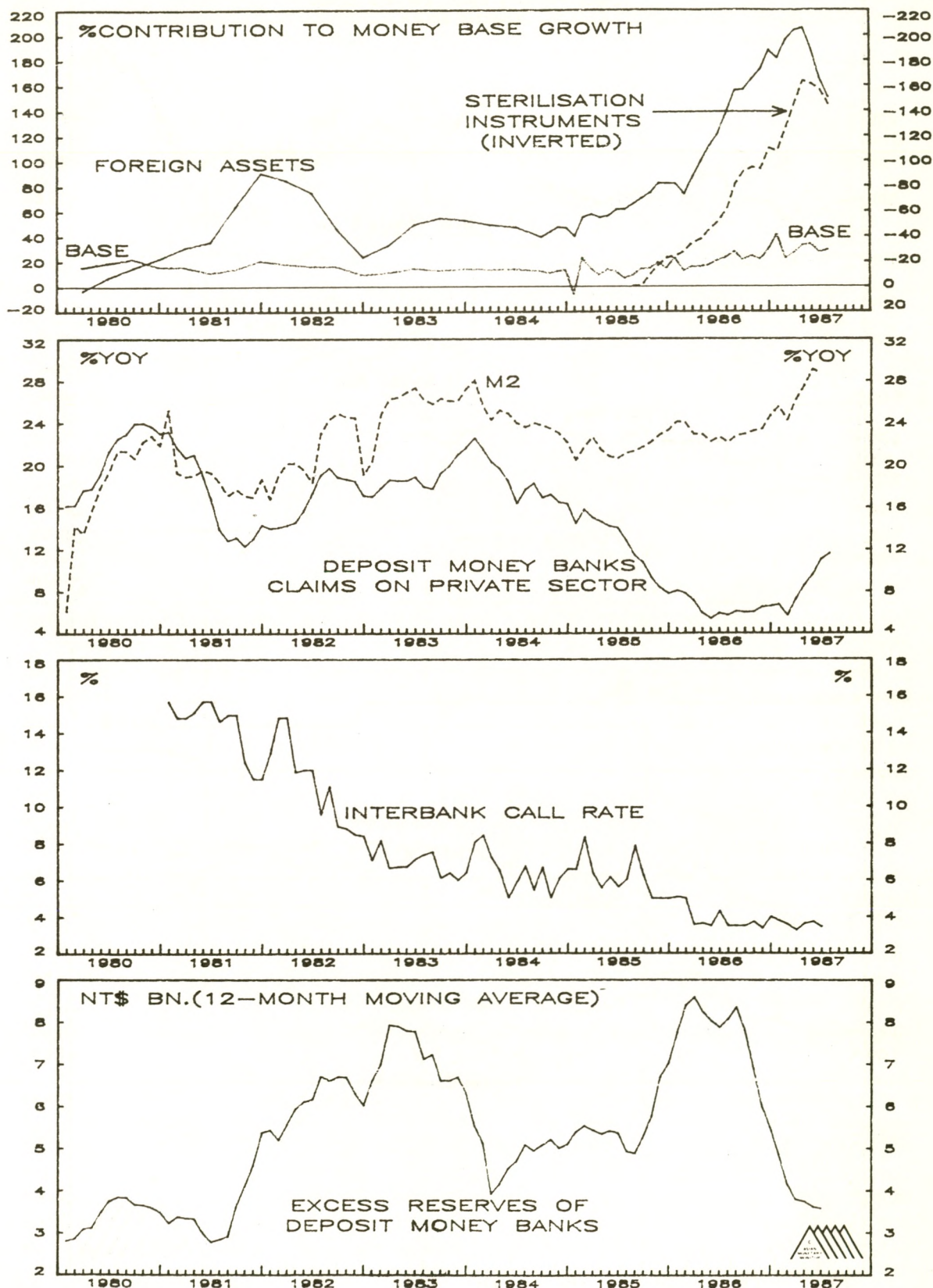
TAIWAN: THE CENTRAL BANK IS ACCOMMODATING A RISE IN LOAN DEMAND



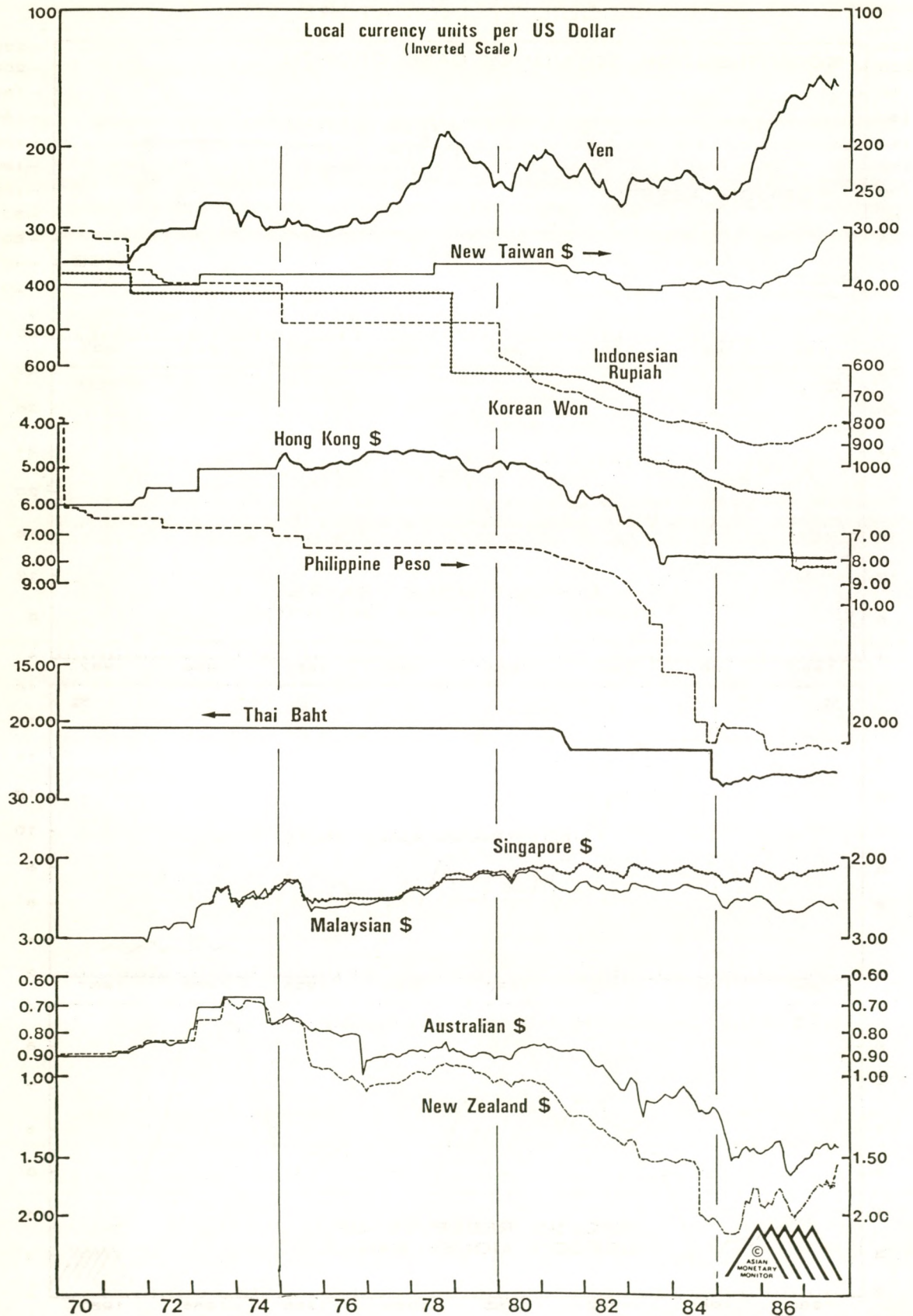
After having managed to maintain a comparatively stable rate of broad money growth simultaneously with an under-valued exchange rate and a burgeoning balance of payments surplus for nearly three years, during this year the Taiwanese authorities have finally allowed a significant monetary expansion (see chart opposite). It seems most likely that the Central Bank of China (CBC) has felt constrained to accommodate a recovery in private sector loan demand which has occurred as domestic demand has begun a long-awaited improvement. As explained in a previous AMM (AMM Vol. 11 No. 2) the major reason the CBC was previously able to prevent the massive external payments surplus from translating into a sharp rise in money growth was marked weakness in domestic loan demand, which enabled the CBC to sell increasingly large quantities of its own liabilities to the deposit money banks (DMB) in order to sterilise the balance of payments surplus. With demand for bank credit now rising, any attempt by the CBC to increase much further its sales of sterilisation instruments could only result in higher interest rates. As loan demand has risen bank liquidity has already begun to tighten (see lower chart, opposite) but the fact that the CBC has worked to keep interest rates from rising is evidenced by the stability in inter-bank rates.

Foreign reserves showed little growth in June and July (and fell in NT\$ terms) because of moves to restrict banks' foreign borrowings and to free capital outflows. More recently, foreign reserves have begun to rise again because of renewed expectations of NT\$ appreciation. However, with the NT\$ now no longer under-valued and the domestic economy strengthening, import volumes are rising more rapidly than export volumes (see chart above). It is therefore only a matter of time before the trade surplus begins to contract and liquidity in the economy tightens.

TAIWAN LIQUIDITY INDICATORS



EXCHANGE RATES IN THE FAR EAST





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REGIONAL SURVEY

WHY S.E. ASIAN EXPORTS HAVE OUTPACED U.S. EXPORTS SINCE THE U.S. DOLLAR PEAKED

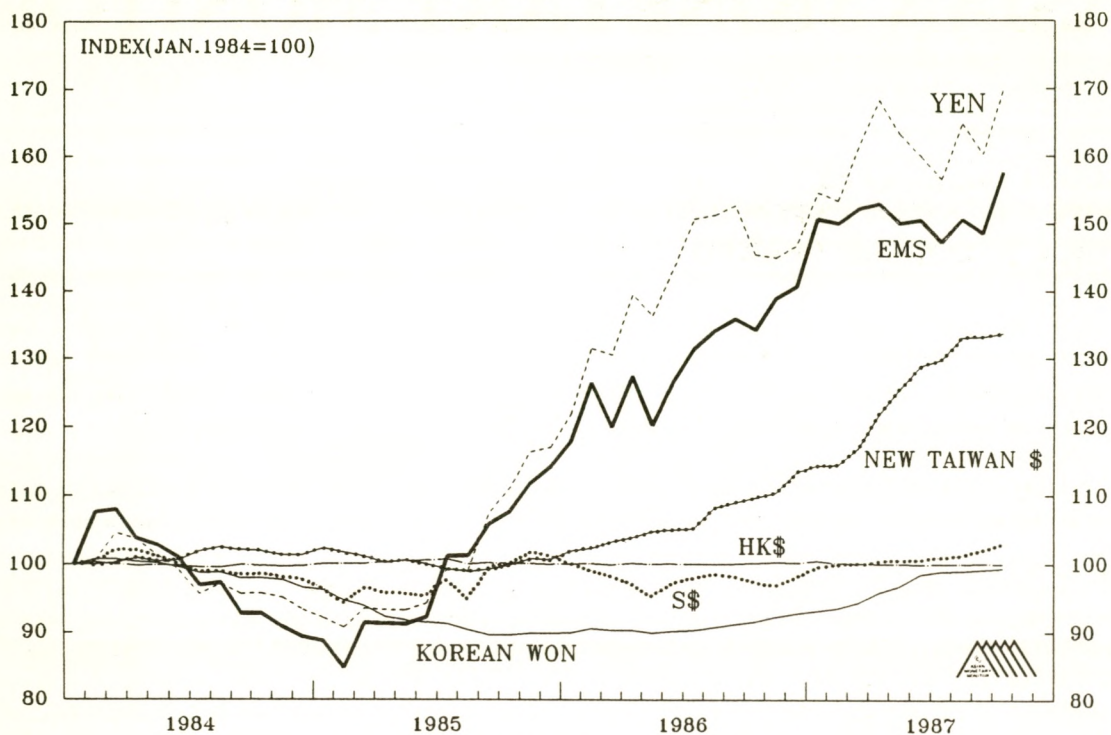
The US dollar peaked in February/March 1985, just over two and a half years ago. To date the US trade deficit has continued to widen in nominal terms, and following the latest surge of imports it is doubtful that there will be any significant narrowing of the US trade gap over the next few months.

By contrast the trade and current accounts of the smaller countries of East Asia, (e.g. South Korea, Taiwan, Hong Kong, Singapore, Thailand, Malaysia and the Philippines), have improved dramatically over the past two years. Following the peaking out of the US dollar there has been a surge in their exports, with exports of the four Asian Newly Industrialised Countries (NICs - i.e. South Korea, Taiwan, Hong Kong and Singapore) growing at over 35% per annum in US dollar terms during the third quarter of 1987. These four NICs export mainly manufactured goods, but even the exports of three commodity producers of S.E. Asia - Thailand, Malaysia, Philippines - are growing at over 20% per annum. The reason for the export-led growth in these economies appears to be closely associated with the fact that their currencies are all tied, more or less tightly, to the US dollar (see Charts 1 and 3). Just as the downturn in export growth in 1984-85 (shown in Chart 2) was caused by the steep appreciation in the US dollar and the matching appreciation of S.E. Asian currencies up until February/March 1985, the export boom which started in late 1985 or early 1986, some 6-9 months after the US dollar began to depreciate, is clearly related to the subsequent improvement in currency competitiveness.

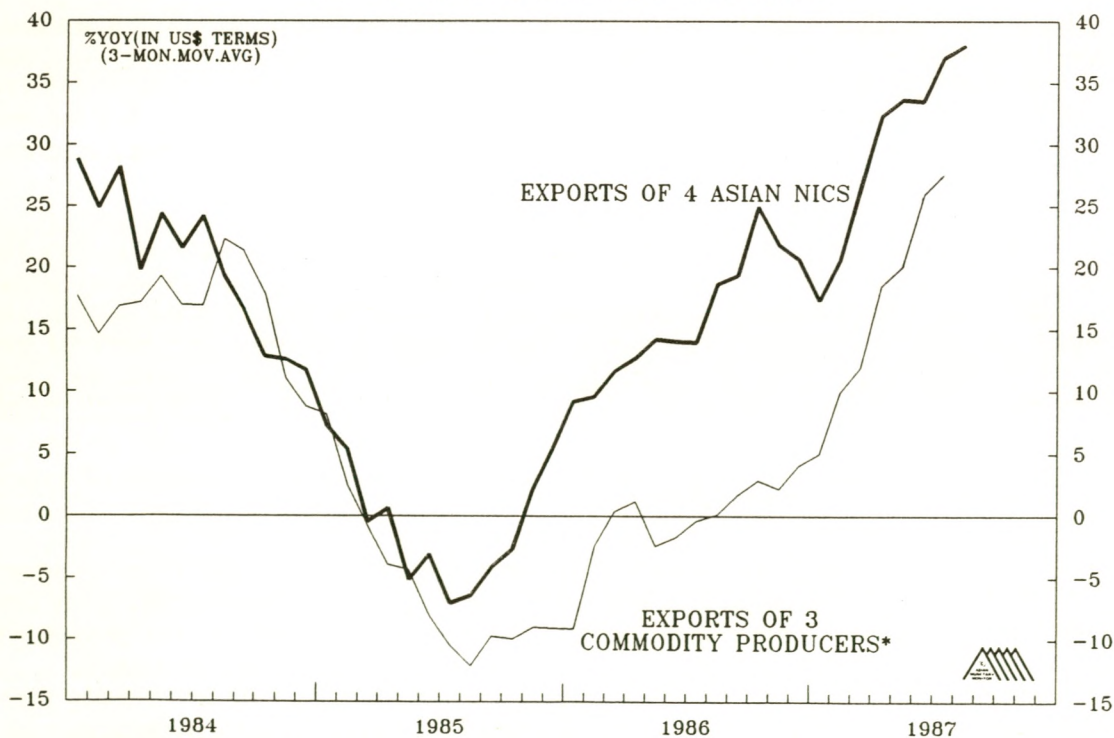
US exports, however, have grown less rapidly than the exports of either the four Asian NICs or the three commodity oriented producers, as shown in Chart 4. Since all these Asian countries, with the minor exceptions of Korea and Taiwan whose currencies have appreciated in recent months, are part of the same US dollar bloc, they should all have enjoyed comparable advantages. Yet there has been a major difference in the export performance of the S.E. Asian economies on the one hand and the export performance of the United States on the other. How can the divergence in export performance between the S.E. Asian economies and the US be explained?

One possible explanation is that relative wage costs are significantly lower in the NICs and in Thailand, Malaysia and the Philippines than in the USA (see Table 1). However, since this wage differential has existed for many years it cannot be invoked to explain the difference in recent performance. An alternative explanation is that the economies of South East Asia are simply more responsive to changes in export opportunities (i.e. export elasticities of demand are higher), but again this idea is unlikely to provide a satisfactory explanation

REGIONAL SURVEY: CHART 1 CURRENCIES OF THE NICs ARE HIGHLY COMPETITIVE



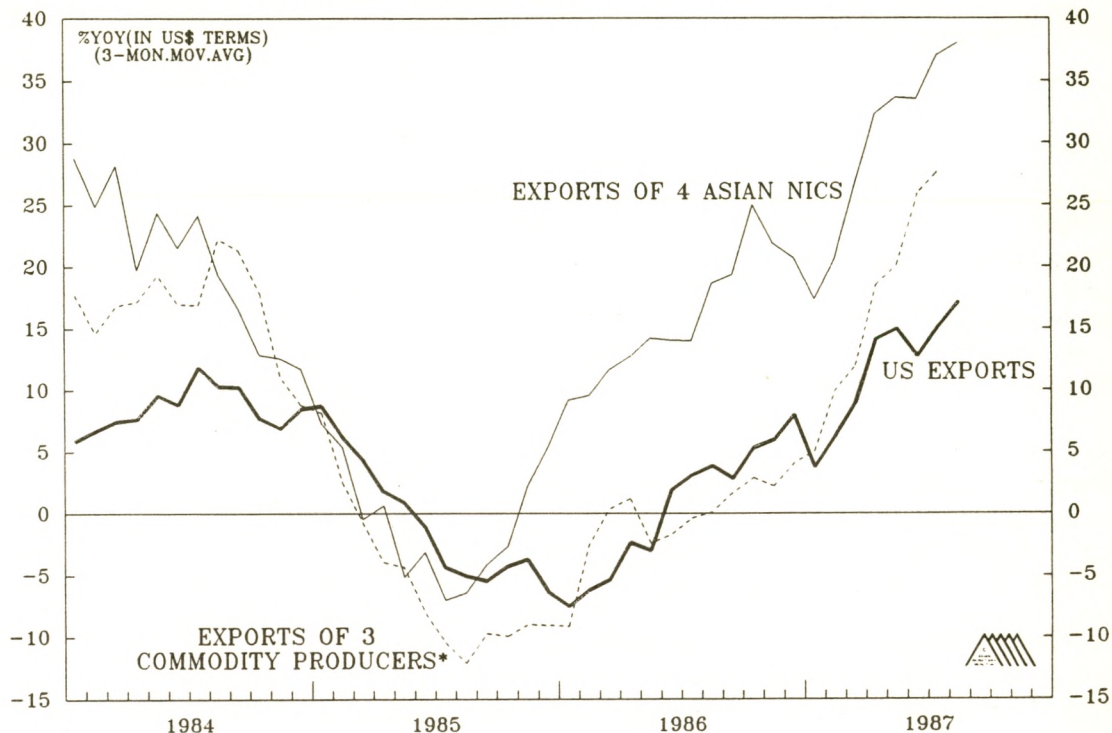
REGIONAL SURVEY: CHART 2 AN EXPORT BOOM FOR THE NICs



*INCLUDE MALAYSIA, THAILAND AND THE PHILIPPINES

REGIONAL SURVEY: CHART 3

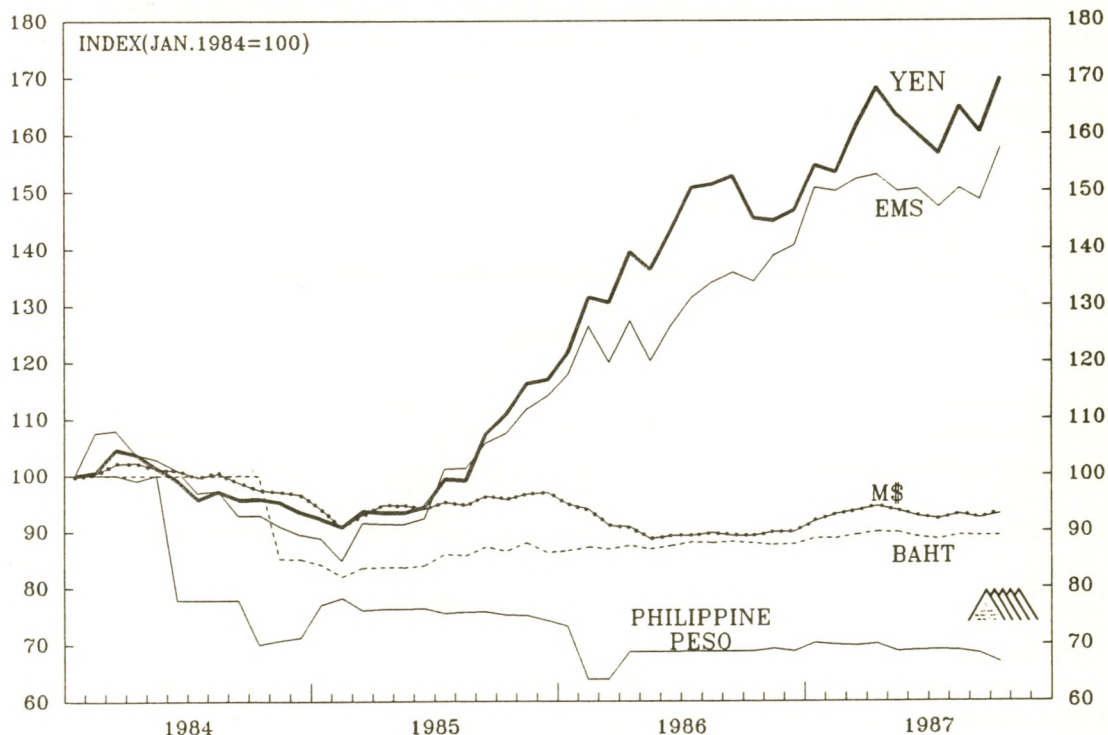
US EXPORTS ARE LAGGING BEHIND S.E. ASIA



*INCLUDE MALAYSIA, THAILAND AND THE PHILIPPINES

REGIONAL SURVEY: CHART 4

CURRENCIES OF S.E. ASIAN COMMODITY PRODUCERS



for the wide difference in export performance.

Table 1.

MANUFACTURING WAGE COSTS PER HOUR (in US\$).

	<u>1984</u>	<u>1985</u>	<u>1986</u>
South Korea	1.38	1.41	1.38
Taiwan	1.48	1.45	1.50
Hong Kong	1.60	1.78	1.78
Singapore	2.41	2.44	2.42
NICs Average	1.72	1.77	1.77
U.S.A.	12.82	13.19	13.47
Japan	6.35	6.45	9.22

Source : U.S. Dept. of Labor,
Bureau of Labor Statistics; G.T. Estimates.

A more credible explanation is that the difference in export performance can be explained by the significant divergence in the respective product mixes of South East Asia and the U.S. By virtue of the fact that they have linked their currencies to the US dollar, the countries of South East Asia are all part of the dollar bloc, and, with the devaluation of the dollar, both US exports and SE Asian exports should have benefited together. The reason that South East Asia has been the major beneficiary of US dollar devaluation rather than the United States is that South East Asia produces mainly manufactured consumer goods, and it is expenditure on consumer goods in the US economy which has been leading the current business cycle. Table 2 shows that consumer goods account for roughly 50% of the exports of the four East Asian NICs (i.e. South Korea, Taiwan, Hong Kong and Singapore) while commodities and raw materials account for some 13-15%. Capital goods, which include some intermediate items such as precision machinery, account for 25-30% of total exports.

Table 2.

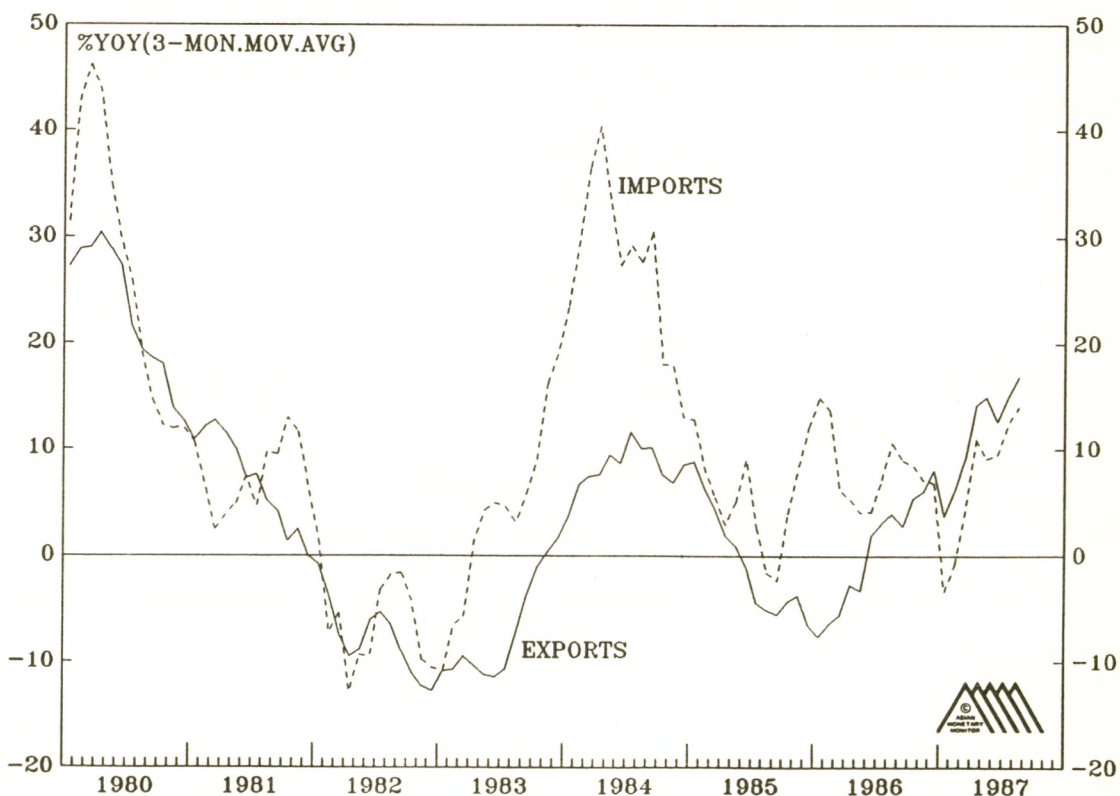
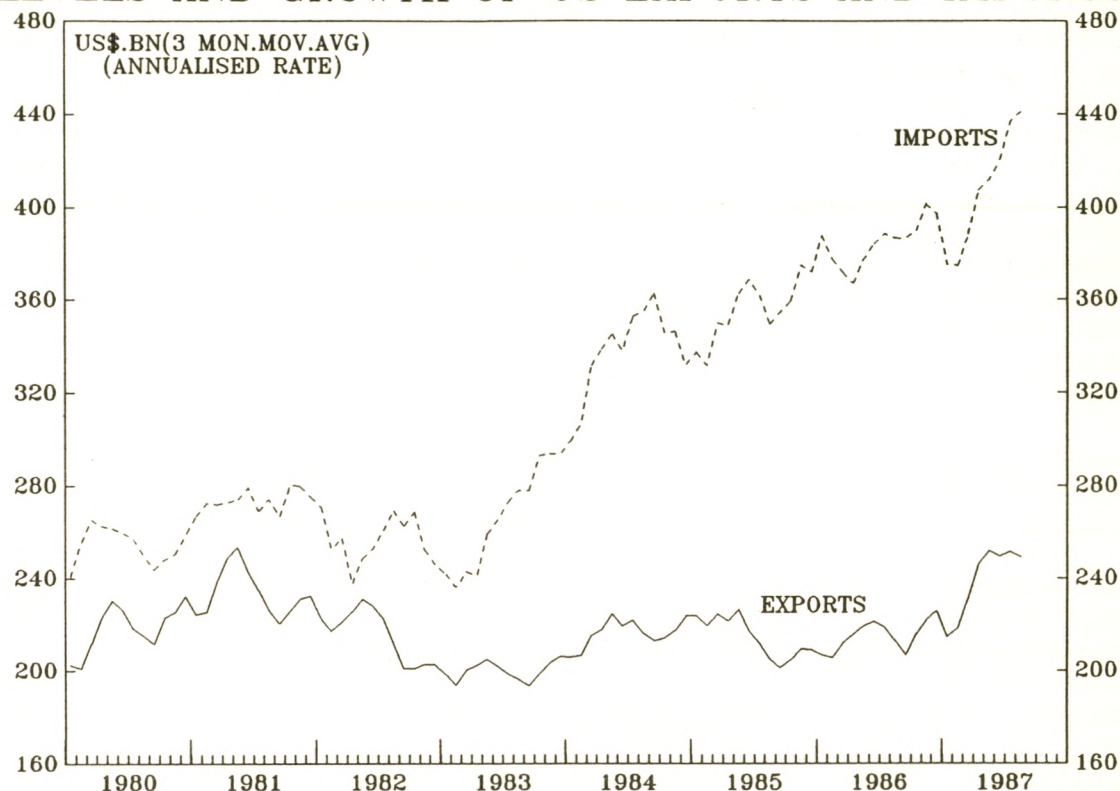
EXPORTS OF 4 ASIAN NICs (in US\$ mn).

	<u>1985 (% share)</u>		<u>1986 (% share)</u>	
Commodities	15,658.9	(15.6)	14,884.7	(12.8)
Capital goods	25,104.9	(25.0)	36,566.9	(31.3)
Manufactured/Consumer				
Goods	50,477.5	(50.2)	53,697.4	(46.0)
Others	<u>9,353.2</u>	<u>(9.3)</u>	<u>11,569.1</u>	<u>(9.9)</u>
TOTAL	100,603.8	(100.0)	116,726.1	(100.0)

The economies of Thailand, Malaysia and the Philippines are traditionally more dependent on commodity exports than the four NICs, but in recent years

REGIONAL SURVEY: CHART 5 & 6

LEVELS AND GROWTH OF US EXPORTS AND IMPORTS



their export product mix has been changing. In 1986 almost half the exports of these three economies consisted of non-traditional, non-commodity items. Manufactured goods now account for approximately 40% of the exports of these countries, most of these being consumer goods rather than capital goods. As a result the combined export performance of these three economies since the peak in the US dollar in February/March 1985 is less striking than the export performance of the NICs, but nevertheless it has been leading the export growth of the US through 1987. At a later stage in the cycle when commodity prices start to rise more steeply one should expect export growth of the three Asian commodity producers to outstrip that of the four Asian NICs, but that period is still many months in the future. In the wake of the crash on world stock markets it is probable that it has been postponed still further.

Table 3.

EXPORTS OF 3 ASIAN COMMODITY PRODUCERS* (in US\$ mn).

	<u>1985 (% share)</u>		<u>1986 (% share)</u>	
Commodities	15,693.5	(58.1)	14,183.7	(51.8)
Capital goods	3,161.8	(11.7)	3,767.0	(13.8)
Manufactured/Consumer				
Goods	5,208.8	(19.3)	6,070.1	(22.2)
Others	<u>2,956.2</u>	<u>(10.9)</u>	<u>3,330.9</u>	<u>(12.2)</u>
TOTAL	27,019.6	(100.0)	27,360.0	(100.0)

* Malaysia, Thailand and the Philippines.

Table 4.

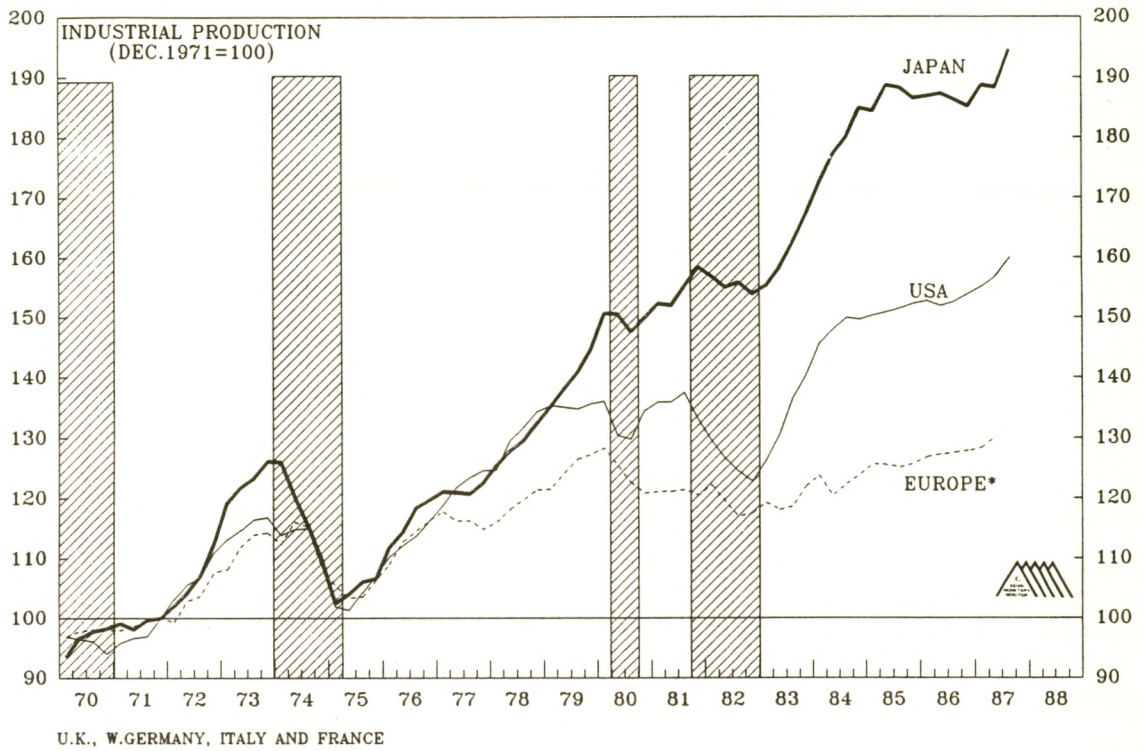
U.S. EXPORTS (in US\$ mn).

	<u>1985 (% share)</u>		<u>1986 (% share)</u>	
Commodities, raw materials				
food, fuel etc.	66,248.1	(31.3)	61,326.4	(29.2)
Capital Goods	94,278.3	(44.6)	95,289.8	(45.4)
Manufactured and semi-				
manufactured goods	<u>51,105.8</u>	<u>(24.1)</u>	<u>53,400.3</u>	<u>(25.4)</u>
TOTAL	211,632.2	(100.0)	210,016.5	(100.0)

On the US side, as shown in Table 4, US exports are accounted for largely by agricultural products and other commodities and fuels (30%), and capital goods such as aircraft, computers and other high tech equipment (45%). Overall US exports have shown a definite upturn since the start of 1987 (see Charts 5 and 6), but despite dollar devaluation the US has had very limited success in increasing its exports of agricultural products because the major markets into

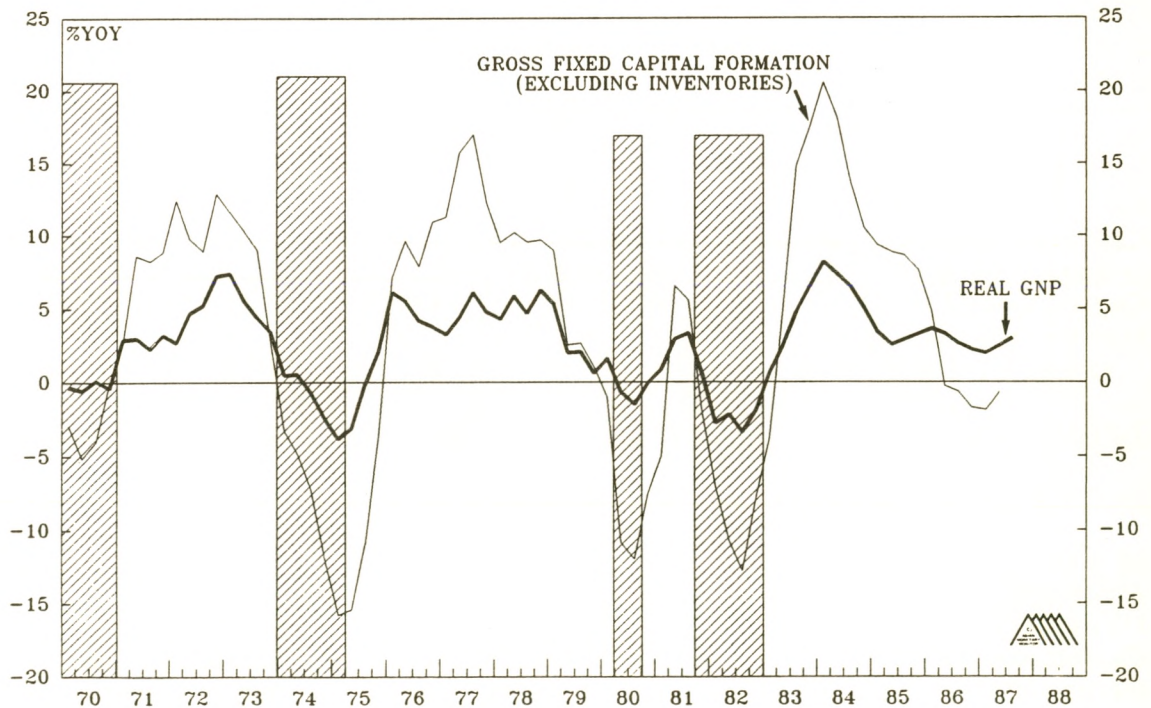
REGIONAL SURVEY: CHART 7

GLOBAL BUSINESS CYCLE EXPANSION STILL INTACT

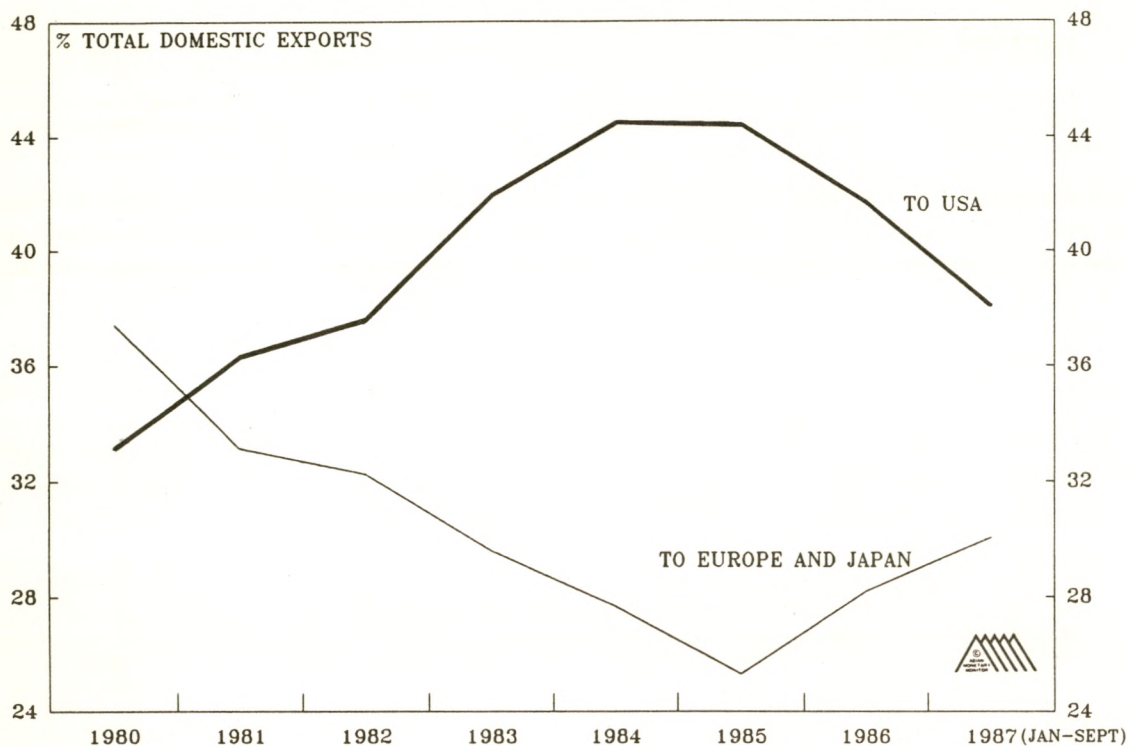


REGIONAL SURVEY: CHART 8

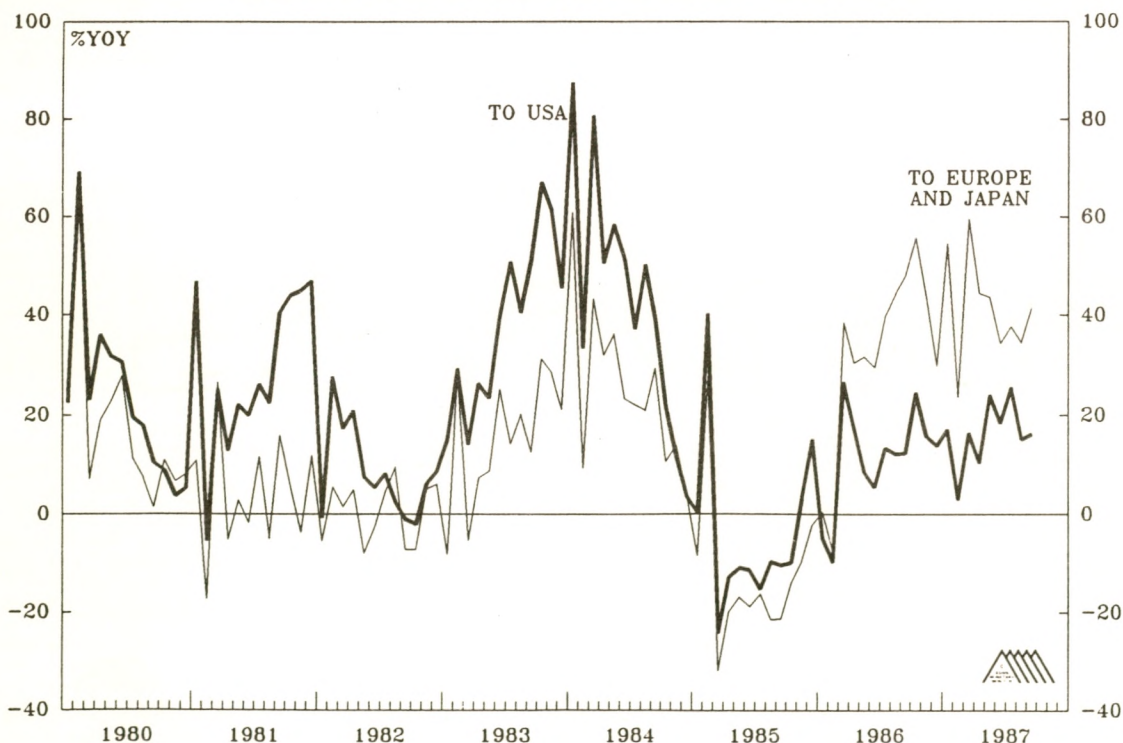
US REAL GNP AND CAPITAL EXPENDITURE



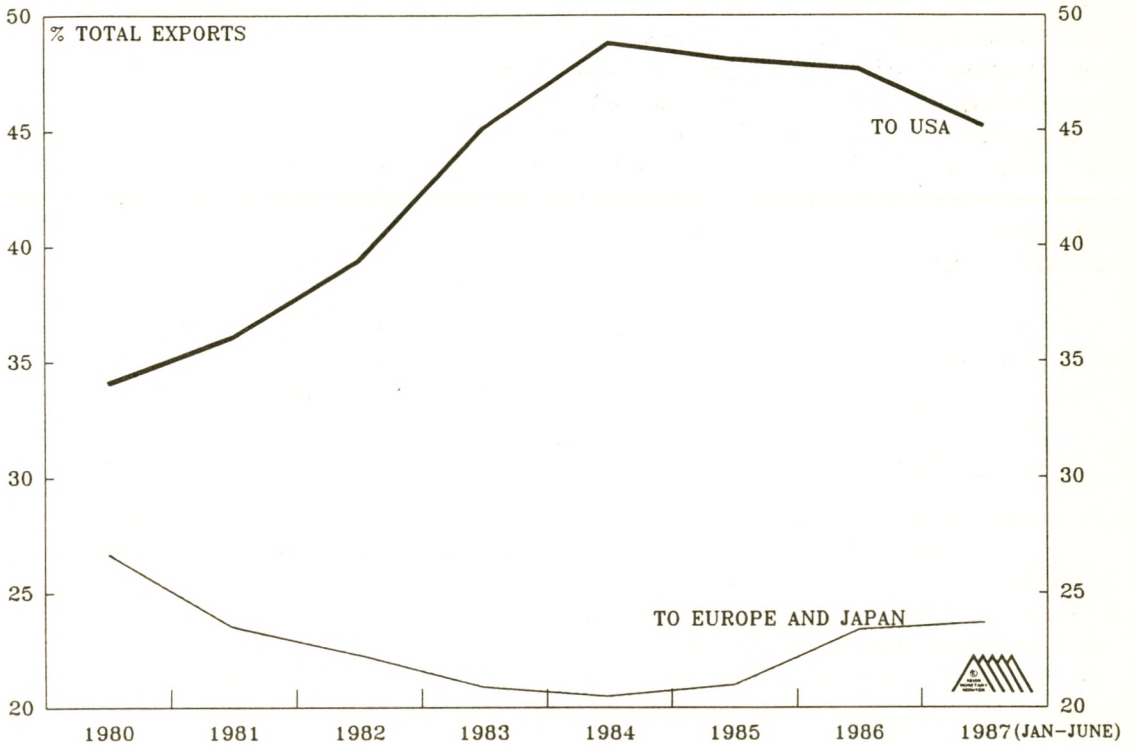
REGIONAL SURVEY: CHART 9 HONG KONG DOMESTIC EXPORT SHARES



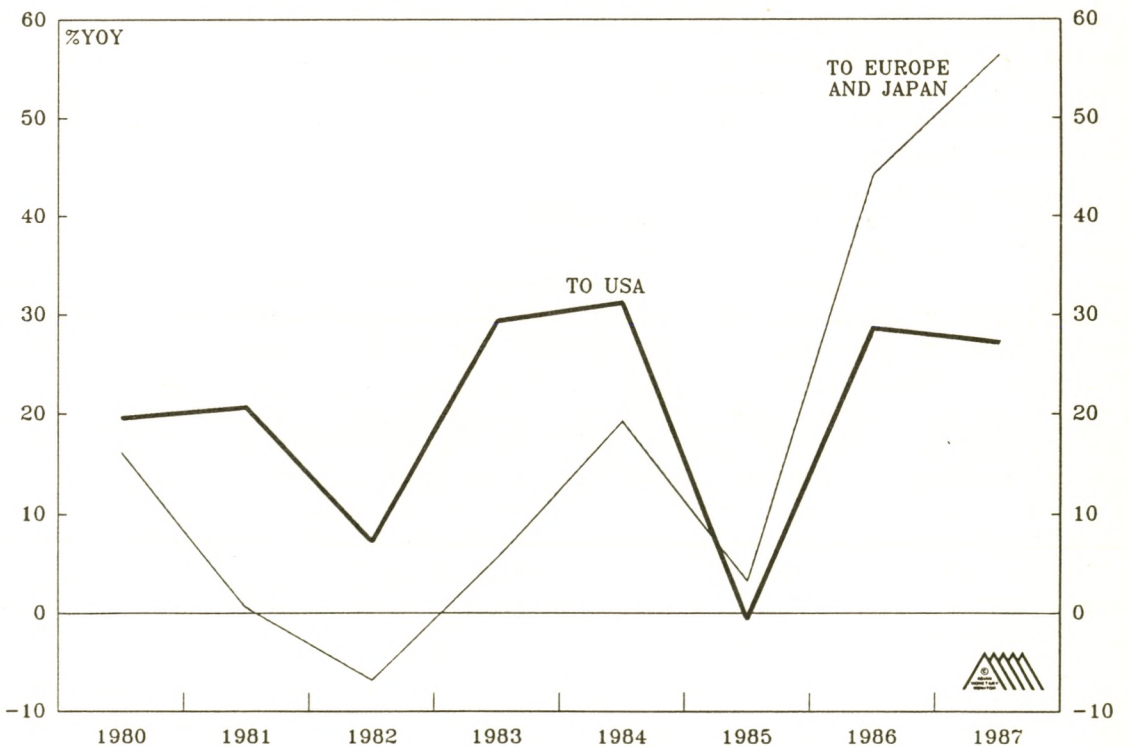
REGIONAL SURVEY: CHART 10 HONG KONG DOMESTIC EXPORT GROWTH



REGIONAL SURVEY: CHART 11 TAIWAN EXPORT SHARES



REGIONAL SURVEY: CHART 12 TAIWAN EXPORT GROWTH



which it sells those products, such as Europe, Japan and the U.K., are restricted by quotas, tariffs, non-tariff barriers and a variety of other protectionist devices. Consequently, no matter how low the US dollar falls, US sales of agricultural products will not respond significantly to this price advantage. As for US exports of capital goods, it is an unfortunate fact that the boom in capital goods normally occurs during the late stages of a business cycle expansion and, so far, the world as a whole has not yet reached that stage in the present cycle. (See Charts 7 and 8). The pre-conditions for a boom in capital spending and hence a boom in US exports require the major economies (Japan, Germany, the United Kingdom and the United States itself) to be close to full capacity utilization both in the use of capital equipment and in the labour markets.

Additional evidence that it is the currency effects of dollar devaluation which are the prime source of South East Asia's export-led boom can be found in the relative growth rate of exports from individual countries of the region to Europe and Japan on the one hand and the USA on the other. Chart 9 shows the shares of Hong Kong's domestic exports shipped to the USA and Japan plus Western Europe in recent years. From a peak of 45% in late 1985, exports to the US have declined in the past two years to around 37% of Hong Kong's total exports. Chart 10 shows the same development from the perspective of the growth rate of Hong Kong's domestic exports: whereas in 1983-85 exports to the U.S. clearly led the overall export recovery, since 1986 exports to Europe and Japan are showing growth rates in excess of 40% year-on-year while exports to the United States are growing at somewhat less than 20%. Despite the appreciation of the NT\$, Taiwan is experiencing exactly similar trends in the composition and growth rate of its exports.

CONCLUSION

In the past when currency movements have been less great, the normal pattern has been for the business cycle of South East Asian economies to follow the US business cycle. However, because currency movements have been so great in the current business upswing (from 1983), the degree of dependence of South East Asian economies on the United States has changed. In a trade sense South East Asian economies are now less dependent on the US; in a monetary sense the South East Asian countries are more dependent on the US by virtue of having linked their currencies to the US dollar.

Based on this analysis one can say that in the present business cycle upswing South East Asia has represented the leading edge of the economic recovery in the dollar bloc. Assuming the Federal Reserve system is able to restore liquidity to financial markets and hence maintain economic growth in the wake of the October stock market crash, the world economy will avoid recession and will be approaching the mature stages of business cycle expansion by mid-1988 or early 1989. On the same assumptions the export-led boom in South East Asia can therefore be read as a portent of strong growth in US production in 1988 and 1989 - and especially the production of capital goods for export. The dollar bloc is recovering, but just as California may recover ahead of Texas, South East Asia is booming ahead of the United States of America.

SPECIAL TOPIC

THE GLOBAL STOCK MARKET CRASH AND IMPLICATIONS FOR EAST ASIAN ECONOMIES

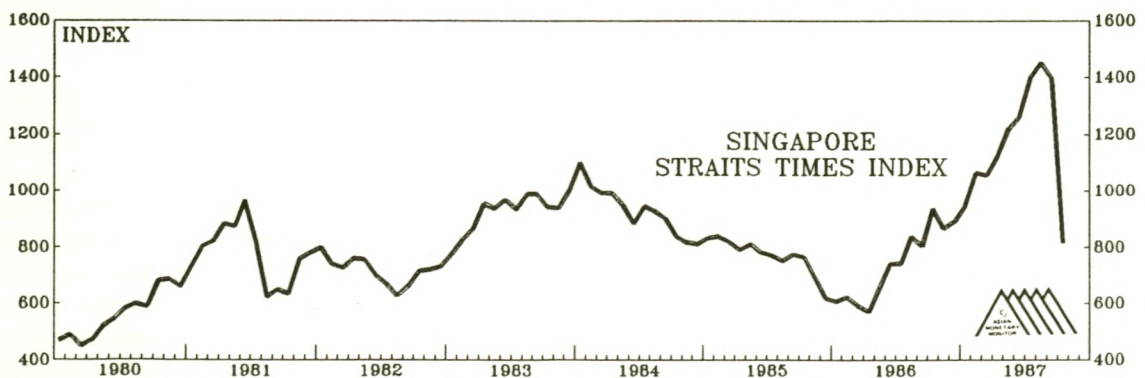
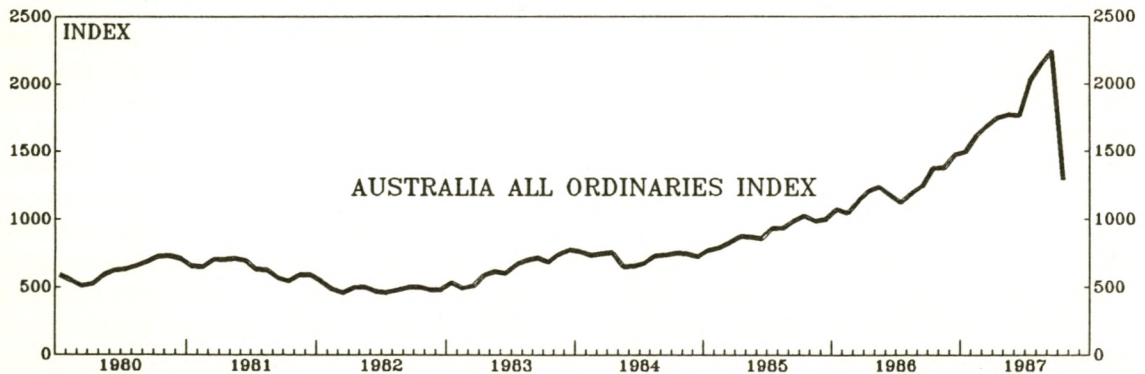
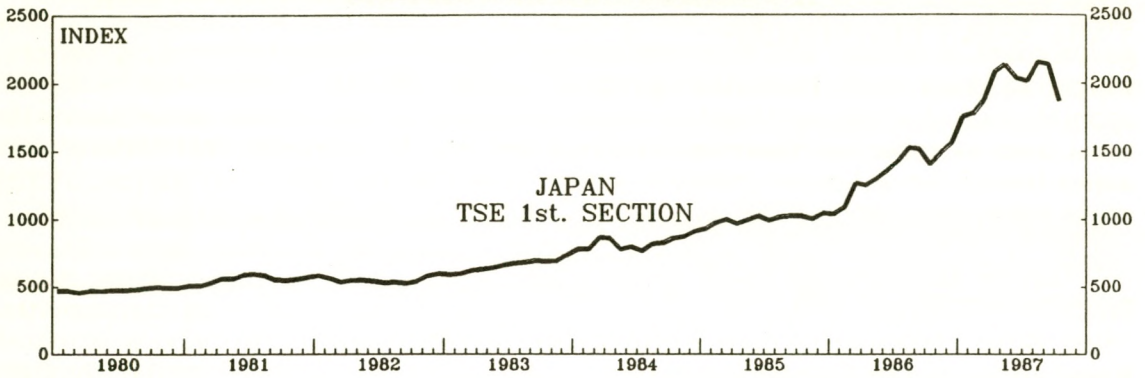
The October collapse of the world's equity markets has focused the attention of the financial markets, economists and the media on the possibility of a world recession. The smaller economies of the Pacific Rim are seen as particularly vulnerable to a world recession because of their 'openness' and orientation towards export-led growth (particularly in the case of Hong Kong, Singapore, Taiwan and Korea) and/or their relative dependence on commodities (Australia, Malaysia, Indonesia, Philippines and Thailand). Reflecting this feared vulnerability those Pacific Rim stockmarkets (other than Japan) which are fully open to foreign investment have been amongst the worst performing equity markets during the market crash. During the final three weeks of October, encompassing 'Black Monday' October 19th, the Hong Kong, Singapore/Malaysia and Australian stockmarkets each fell between 42% and 44% as measured by their respective indices compared to smaller falls of 20%, 14% and 27% in the US, Japanese and UK equity markets (see Chart 1).

Many observers have noted that if stockmarkets are judged to be efficient forecasters of trends in corporate earnings then the magnitudes of the declines in the markets implies a high probability of a major slowdown in economic growth (and possibly an economic contraction), not least in the Asian region. Further, as far as the larger stockmarkets (and in particular the US) are concerned, much analysis of the 'crash' has assumed that the declines in these equity markets are themselves enough to cause a recession, through the negative impact on consumer spending, via the 'wealth effect', and the effect on confidence. This argument hypothesises that consumers will respond to the loss of net worth and uncertainty resulting from the crash by restraining expenditure, particularly on consumer durables, while businesses will also respond to increased uncertainty, the possible drop in consumer spending and the increased cost of equity funding by slashing investment. Although reasonable as far as they go, however, these views do not represent a comprehensive picture of the stockmarket collapse and therefore of the likely economic consequences. To treat the market collapse as a causal, or exogenous, factor in economic trends is incorrect and taken to the extreme makes stock market movements self-fulfilling prophecies. In reality, of course, stock prices, like the prices of other assets and goods, are not exogenous factors in economic growth but the results of wider monetary and economic forces. Before any conclusions can be drawn about the implications of the stockmarket collapse, it is therefore first necessary to examine the possible economic causes of the crash.

What Caused the October Stock Market Crash?

Economists have advanced various possible explanations for the global equity market collapse. The most widely accepted theory is that the 'twin deficits' of the US were ultimately responsible. The argument is that the US budget deficit and the US trade deficit plus the growing external indebtedness of the US had reached unsustainable levels, and that foreigners were therefore no longer willing to hold US dollar assets. In order to narrow the budget deficit

CHART 1
PACIFIC RIM STOCKMARKETS



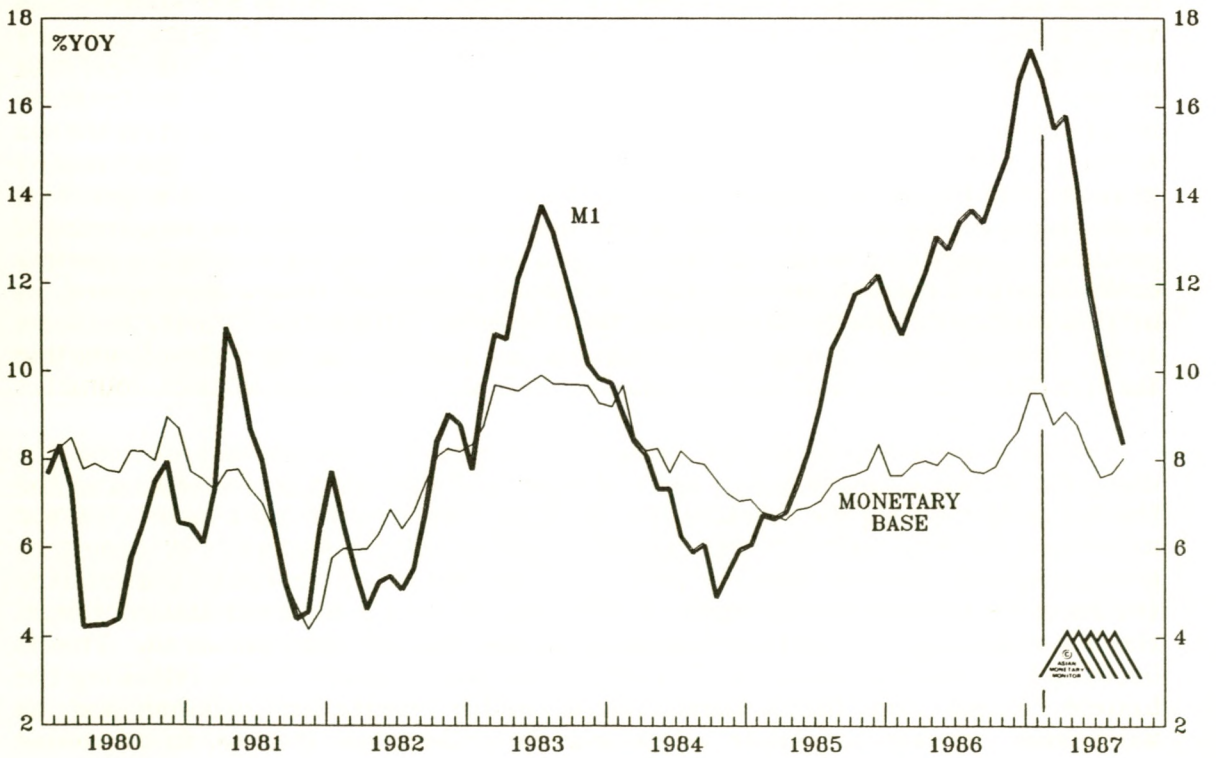
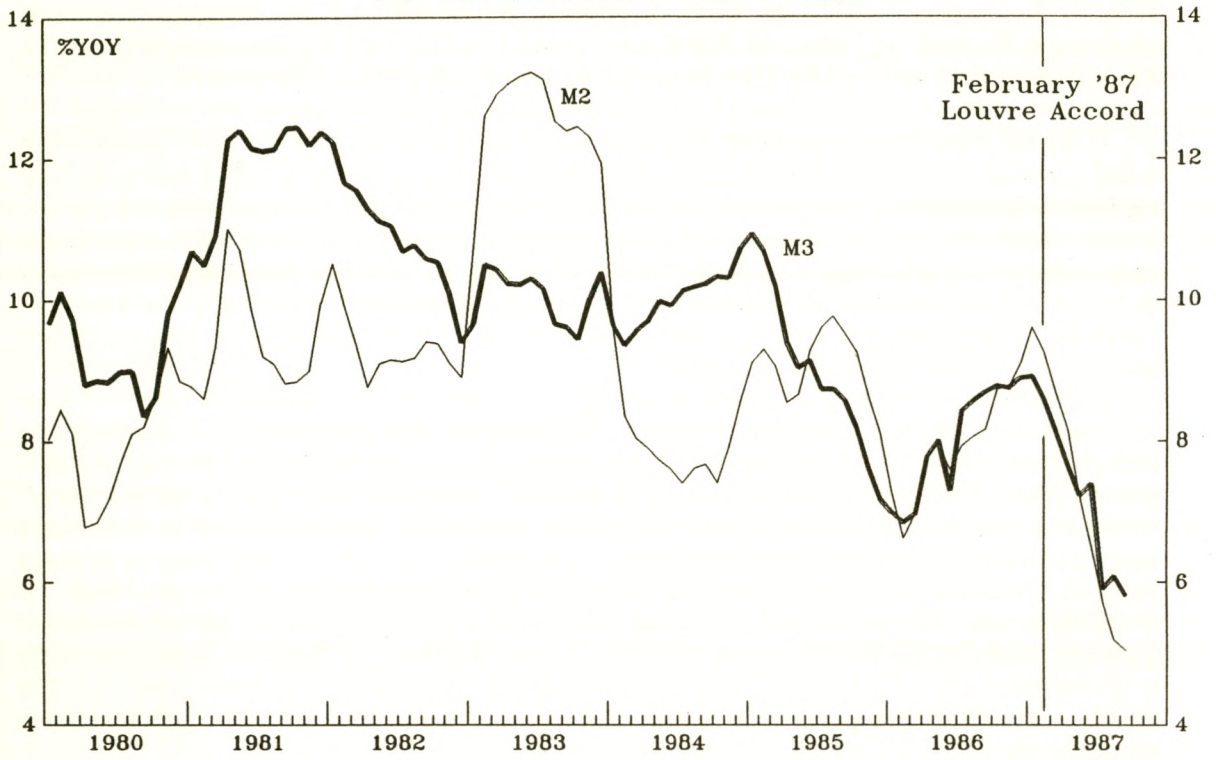
either taxes must be raised or government spending must be lowered, or there must be some combination of these two. In a Keynesian view of the world any of these three steps will temporarily produce a reduction in consumer and/or government spending, and thus precipitate at least a minor economic downturn, which in turn will cure the external trade deficit. President Reagan's appointment of a special task force to negotiate a package along these lines with the Congress indicates that the President and the White House staff (along with many foreign investors in the US) adhere at least partially to this view of the appropriate remedy.

However, although the 'twin deficits' were probably a contributory factor in the stockmarket crash, they can not be seen as the overriding fundamental cause of the collapse. Theoretically, according to monetarist analysis, it is the financing of the budget deficit rather than the size of the deficit which matters for the economy. For any given level of the money supply and income velocity, raising taxes or reducing government expenditure simply transfers funds from the private sector to the government sector, or vice versa, and does not affect the overall level of spending and income in the economy. Although foreign investors can choose to finance a greater or lesser proportion of the budget deficit through their purchases of treasury bonds, the effects of changes in such foreign investment behaviour should be accommodated by the exchange rate for the dollar, and hence through changes in the composition of GNP, rather than the overall level of economic activity. More practically, perhaps, it is difficult to believe that the US budget deficit could have been the ultimate cause of the equity market crash when it has been on a declining trend through 1987, falling from an annualised rate of close to US\$200 billion in the latter part of 1986 to an annualised rate of US\$150 billion in the third quarter of 1987.

A second explanation advanced for the global crash in the stockmarkets is the gradual rise in interest rates since April 1987. The rise in rates had two main components. First, long term US government bond yields rose from 7.5% in March to 10.5% immediately prior to the crash on account of an increase in inflationary expectations and, to a lesser degree, as a result of rising economic activity. Second, central banks raised interest rates - in particular the Bank of England, the Federal Reserve System and, later, the Bundesbank. The problem with this view is that inflation has actually slowed down in recent months, particularly producer prices in the US, and also that the tightening by central banks followed market interest rates upward rather than anticipated them. In other words, although the rise in long term interest rates was sufficient to cause a major adjustment in stock prices it was not possible to say that all central banks tightened particularly aggressively. In fact, yield curves in most countries remained positive.

The third explanation for the collapse in stock prices is to be found in the behaviour of money growth rates of major countries since the agreement in Paris in February 1987 which has become known as the Louvre Accord. According to this agreement among the G-7 nations, exchange rates were to be stabilised within quite narrow ranges pending recovery in the US external trade deficit. Since the Louvre Accord there has been large-scale intervention in the foreign exchange markets by the Bank of Japan, the Bundesbank and the Federal Reserve System. Intervention by the Bank of Japan and the Bundesbank has led to much more rapid monetary growth in Japan and West Germany than would otherwise

CHART 2 US MONETARY GROWTH



have occurred. In part these interventions have been sterilised, but nevertheless monetary growth in Japan has accelerated from 8% in December 1986 to over 11% by September 1987. In West Germany, the Central Bank Money Stock has continued to rise at rates of 8-9% per annum, while M3 has remained close to 8%. These are historically high rates of expansion for West Germany.

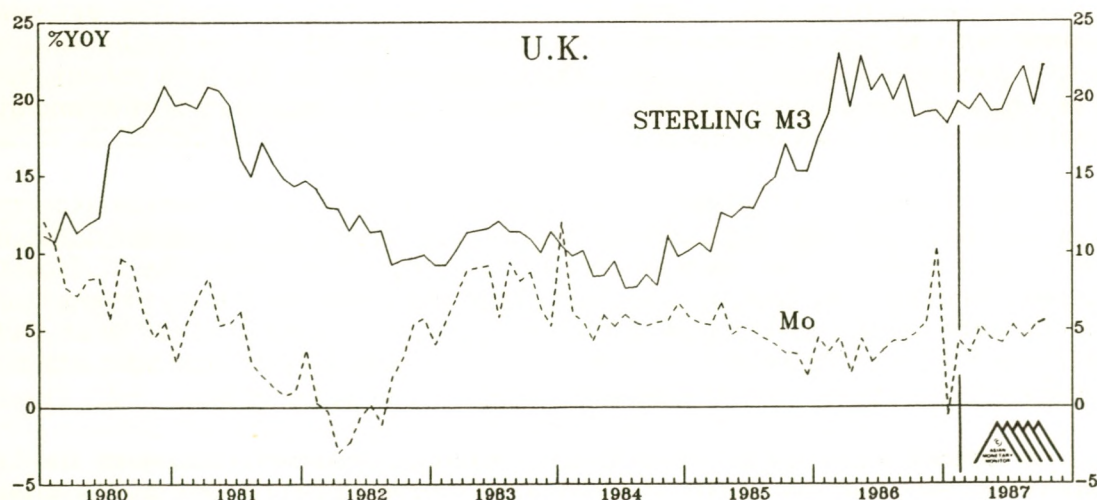
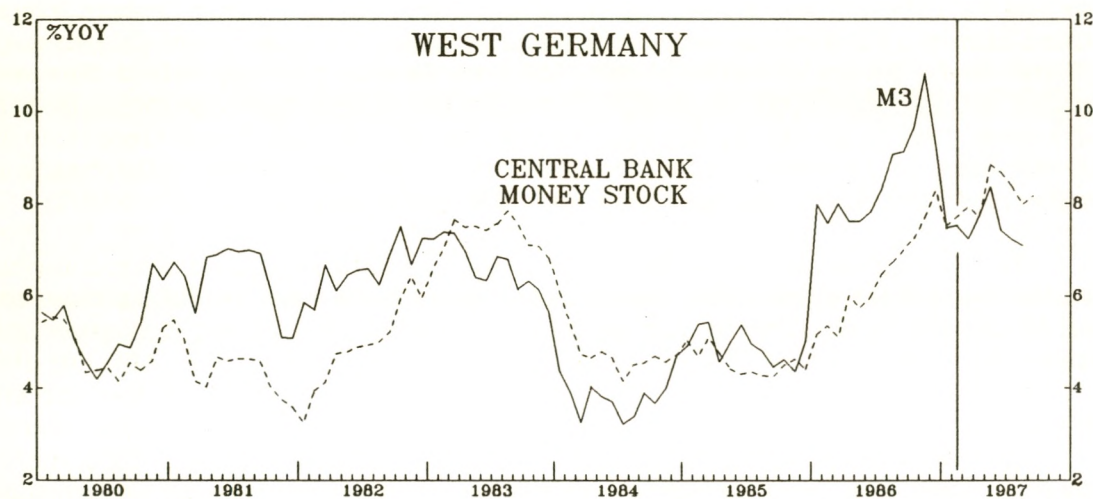
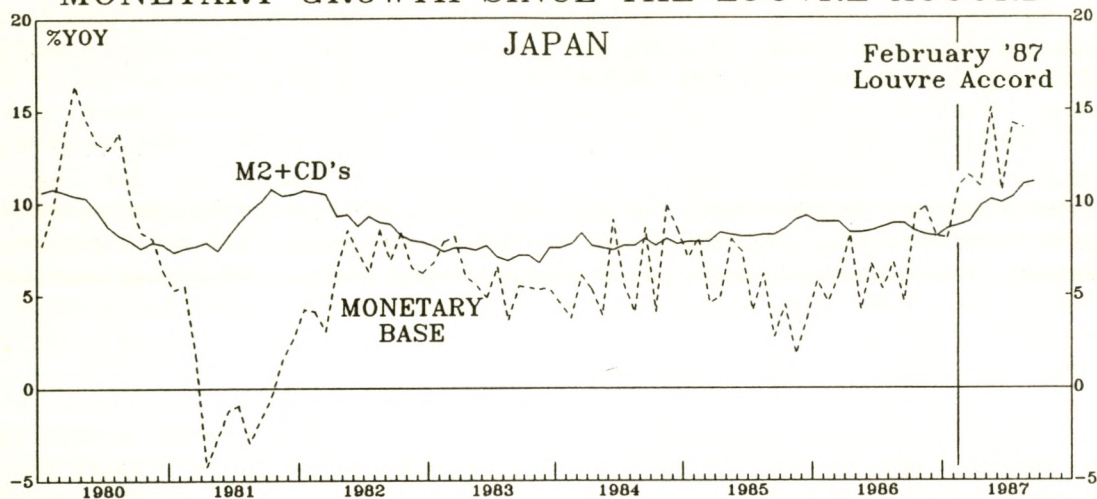
While the Japanese economy has been responding well to this treatment with domestic demand expanding by 4-5% in real terms, so far the German economy appears to have been mesmerised by the adverse consequences of the appreciation in the Deutschemark and has failed, so far, to show any significant upswing. The combined result has been that Japan and Germany together have not yet seen their domestic demand growing sufficiently strongly to cause a reduction of their combined nominal trade surpluses and hence a significant narrowing of the US trade deficit.

On the other side of the Louvre Accord the Federal Reserve system has had to intervene to buy US dollars from the foreign exchange market and - voluntarily or involuntarily - it too has presided over a change in its domestic monetary growth. But whereas Japan and Germany have enjoyed a monetary acceleration, the US has experienced a sharp deceleration. Thus from a growth rate of almost 18% year-on-year at the end of 1986, M1 slowed abruptly to 8.4% in September. On an annualised basis, M1 grew at only 2.9% per annum between January and October 1987 compared with 16% per annum between October 1986 and March 1987. Similarly, M2 has halved its growth rate from close to 10% year-on-year in December 1986 to 5.2% by September 1987. M3 has also decelerated from 9% to just below 6% over the same period.

The suddenness of this slowdown in money growth is unprecedented for the broader aggregates since 1980, except when there have been transfers from one type of deposit to another on account of deregulation. Moreover, it is especially noteworthy that all the major monetary aggregates (M1, M2, M3 and the monetary base) have been decelerating over the past 9 months. It is particularly ironical that this tightening of monetary conditions came at a time when the US economy was strengthening significantly (under the stimulus of rapid money growth in 1986 and the depreciation of the US dollar), and at a time when most analysts had decided that watching the monetary aggregates was an outmoded pastime. What happened, therefore, was that a strengthening US economy collided with an abrupt downturn in the growth of the US money supply, and, as in the standard monetarist analysis, this impacted in the US security markets first. In short, the Louvre Accord was behind the US monetary slowdown, and the monetary slowdown in turn behind the collapse in share prices.

The integration of global financial markets has meant that despite the divergent trends of monetary growth in Japan and Germany on the one hand and the US on the other, the financial shock waves from Wall Street have affected all stock markets. In fact, it is arguable that the divergent trends of monetary growth, with respect to Japan in particular, may have contributed to the crisis in the sense that it made what might otherwise have been a more gradual decline in the US equity market into the sudden collapse that actually occurred. This is because the very easy monetary conditions that developed in Japan following the Louvre Accord were highly conducive to equity investment in Japan and, as valuations in the Japanese stock market consequently rose, to Japanese

CHART 3 MONETARY GROWTH SINCE THE LOUVRE ACCORD



investment in foreign equity markets as well. From January 1st to its mid-October peak the Nikkei Dow Jones Index of the Japanese stock market rose by 42% (see Chart 1), taking the historic price earnings multiple for the index from 45 to 64. With the rising valuation being placed on domestic equities, Japanese institutions increased investment in overseas markets, Japanese net purchases of foreign equities running at an annualised rate of US\$20 billion, nearly three times the level of the previous year (see Chart 4). Much of this investment was directed to US equities, forming an increasingly significant part of the overall capital flow from Japan to the US. It is possible that these foreign purchases of US equities were what kept US stock prices on a basically rising trend between February and August even as domestic liquidity conditions in the US continued to deteriorate in the wake of the Louvre Accord, ultimately setting the stage for the crash when foreign investment could no longer support US equity prices against the increasingly adverse domestic liquidity background.

Given this background, the performance of the world economy over the next several quarters depends crucially on the response of the central banks to the stock market crash. In the wake of the crash the US Federal Reserve moved quickly to a markedly easier monetary stance, increasing the availability of reserves to the banking system and lowering the Federal Funds rate. These actions have been reflected in more rapid reserve growth (see Chart 5), although it is too early, at the time of writing, to know what sustained effect this will have on overall monetary growth. Assuming that monetary growth rises in response to the Fed easing, however, the outcome will be very different from 1929-33. At that time the Fed made major policy mistakes for although it lowered its discount rate on no less than eight occasions in 1929-31, it nevertheless allowed the money supply to decline in absolute terms by one-third. It is inconceivable that this kind of error can be repeated over the next few months. If the financial markets are re-liquified sufficiently quickly and confidence is restored, the economic downturn should be mild and consumer and investment spending should recover later in 1988. The possible cost to this policy, however, might be higher inflation in the later stages of the current business cycle.

Implications for the Asian Regional Economies

In the meantime, the outlook for the East Asian region over the next year depends fairly crucially on the policies adopted by the non-US central banks, and most importantly the Bank of Japan (BOJ). Although, as stressed earlier, the equity market collapse should not be seen as the causal factor in economic growth, but rather the underlying monetary trends which led to the crash, it has nevertheless almost certainly had one important real effect. This is that Japanese investors' perception of the risk inherent in investment in foreign securities will have been significantly heightened. There is already evidence of this from indications that Japanese institutions became net sellers of foreign securities in October, having previously been net purchasers at an annualised rate of over US\$70 billion (See AMM Vol. 11 No. 3). It is clear that this, particularly when taken together with the easier monetary stance now adopted by the Fed, implies significant downward pressure on the US dollar.

In essence Japanese institutions are no longer prepared to finance the US current account deficit at its current slow profile of improvement, but would

CHART 4
JAPAN'S INTERNATIONAL TRANSACTIONS IN SECURITIES

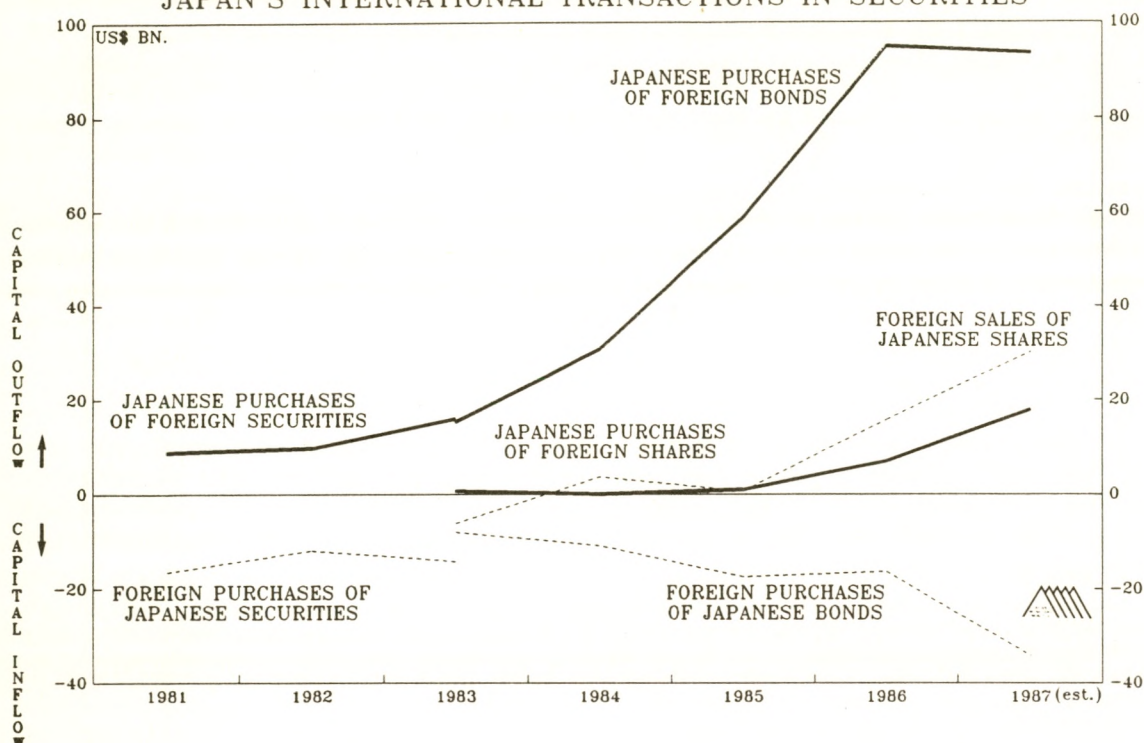


CHART 5
THE FED'S MONETARY STANCE

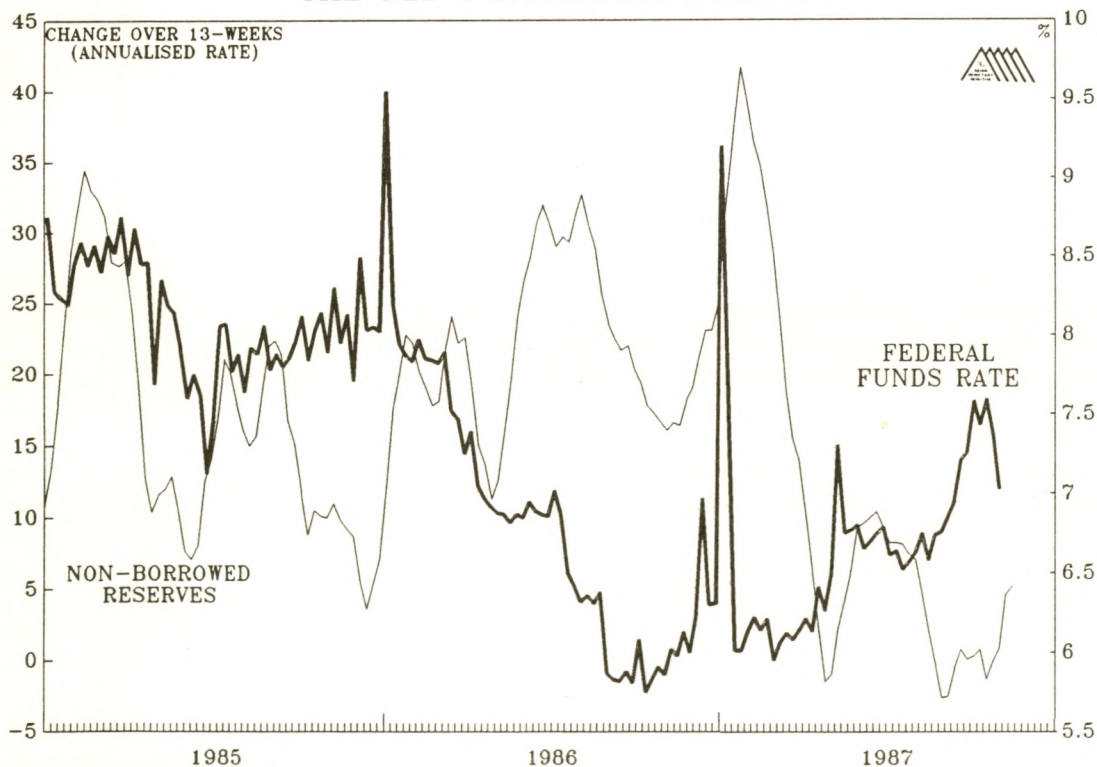


CHART 6
REAL DOMESTIC DEMAND IN THE MAJOR ECONOMIES

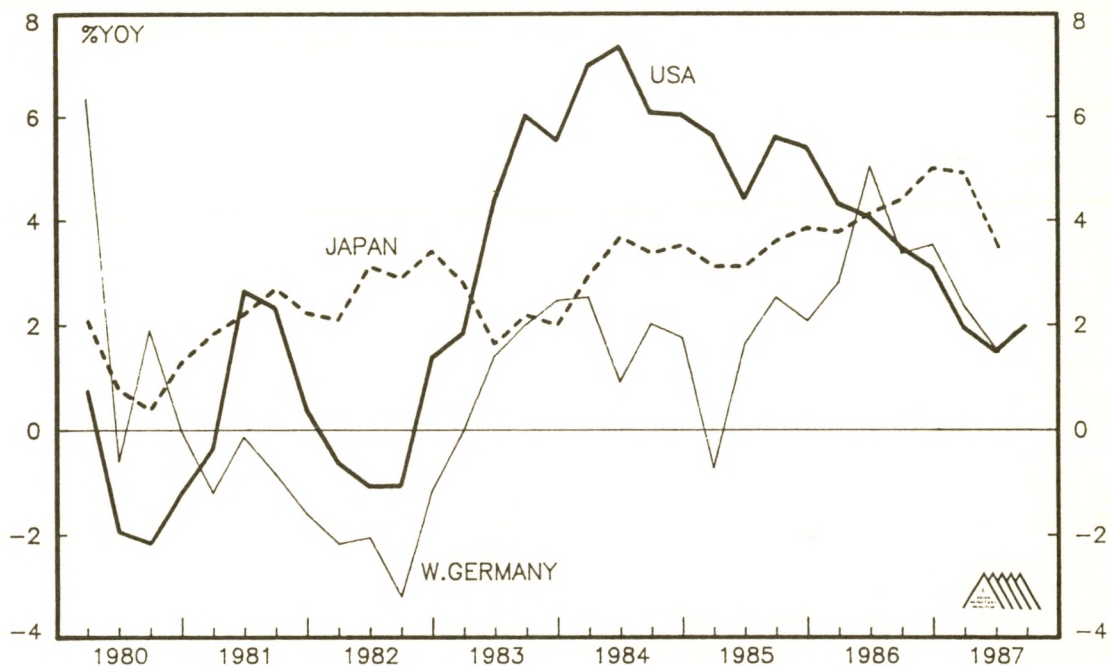
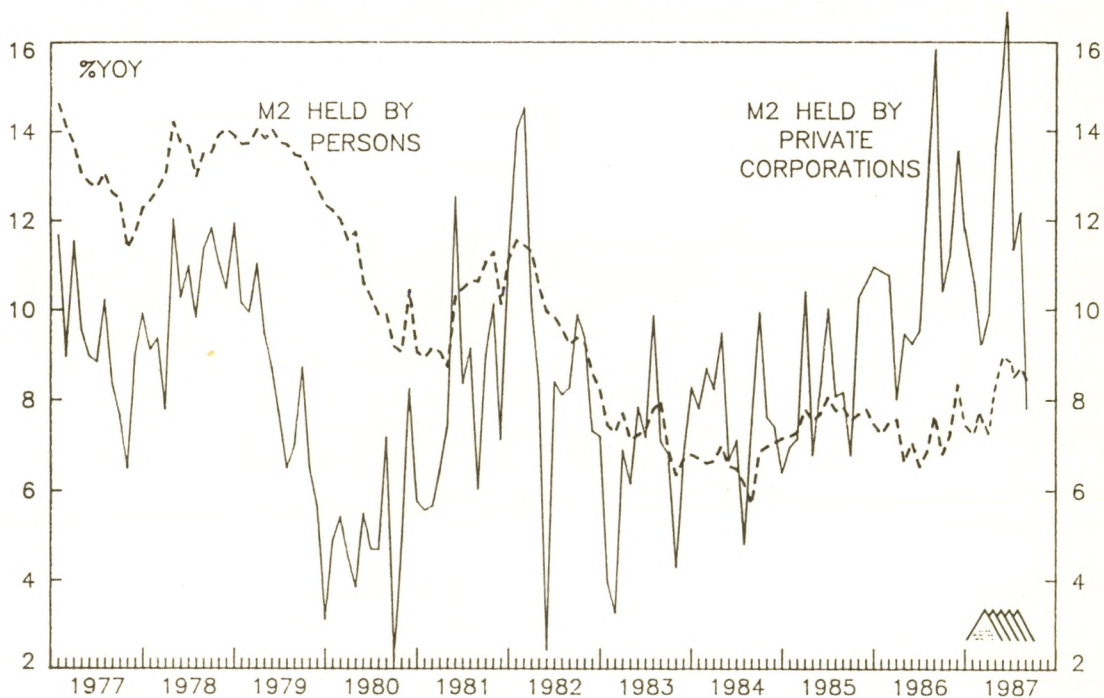


CHART 7
JAPAN: GROWTH OF PERSONAL AND CORPORATE DEPOSITS



only be prepared to finance it at whatever, much lower, level of the dollar would be compatible with a much more rapid improvement in the deficit. Or, to put this in a more popularly understood way, 'the markets' are forcing the trade imbalance between the US and Japan to narrow at a much more rapid rate than hitherto. In these circumstances the BOJ is left with only two basic policy options. It can either allow the dollar to fall to whatever level is necessary to encourage Japanese institutions to continue investing in US securities, thus totally abandoning the Louvre Accord, or alternatively it can continue supporting the dollar, therefore financing the US current account deficit itself and allowing even higher domestic monetary growth as a consequence. The former option can be seen as placing most of the burden of trade adjustment on to US imports and Japanese exports, forcing them both lower and hence increasing the risk of a world recession. The latter would encourage more of the trade adjustment to take place in Japanese imports and US exports, encouraging strong world economic growth but at the ultimate cost of higher worldwide inflation.

Most likely, the BOJ will pursue a middle course, leaning somewhat more towards the latter option. This appears to be the central bank's policy at the moment, as it has been allowing the dollar to drift downwards while easing monetary conditions in Japan still further. Assuming the BOJ continues with this policy, even though a slowdown in US domestic demand over the next one or two quarters is probably assured as a result of the tight US monetary conditions prior to the stock market collapse, domestic demand in Japan should remain strong, and probably strengthen further. This would then merely be a continuation of the respective trends in domestic demand in the two economies in place since 1984/85 (see Chart 6). However, whereas stronger domestic demand growth in Japan over 1986 and the first half of 1987 owed much to strong growth in housing and non-manufacturing investment, from here on growth in Japan is likely to be increasingly consumer-led. Supporting this view, Chart 7 shows that whereas prior to the BOJ's adoption of an easier monetary stance early this year the growth of the private sector's holdings of money had been largely concentrated in the corporate sector, since the easing of monetary conditions following the Louvre Accord personal holdings of money have risen sharply. Furthermore Chart 8, which shows the accumulation of personal sector liquidity in real terms, suggests that the personal sector is now more liquid than at any time since the last Japanese consumer spending boom, in 1978/79.

The major conclusion for the regional economies is that economic conditions are very unlikely to be as poor as the financial markets are apparently anticipating. A point that has been made in previous AMM articles (see, particularly, AMM Vol. 11 No. 4) is that the boom conditions experienced by the East Asian economies in 1987 have had very little to do with US domestic demand - which has not been strong - but much more to do with currency movements and the strength of the Japanese and European economies (see Chart 9). Further strength in the Japanese economy and weakness in the US dollar over the next few months should therefore be seen as positive developments for the regional economies.

From these general observations, it is possible to draw some very basic conclusions about the likely relative performance of the respective regional economies in 1988. In essence, the Asian economies likely to enjoy higher growth rates are those which are better positioned to take advantage of

CHART 8
JAPAN: PERSONAL SECTOR LIQUIDITY AND CONSUMER SPENDING

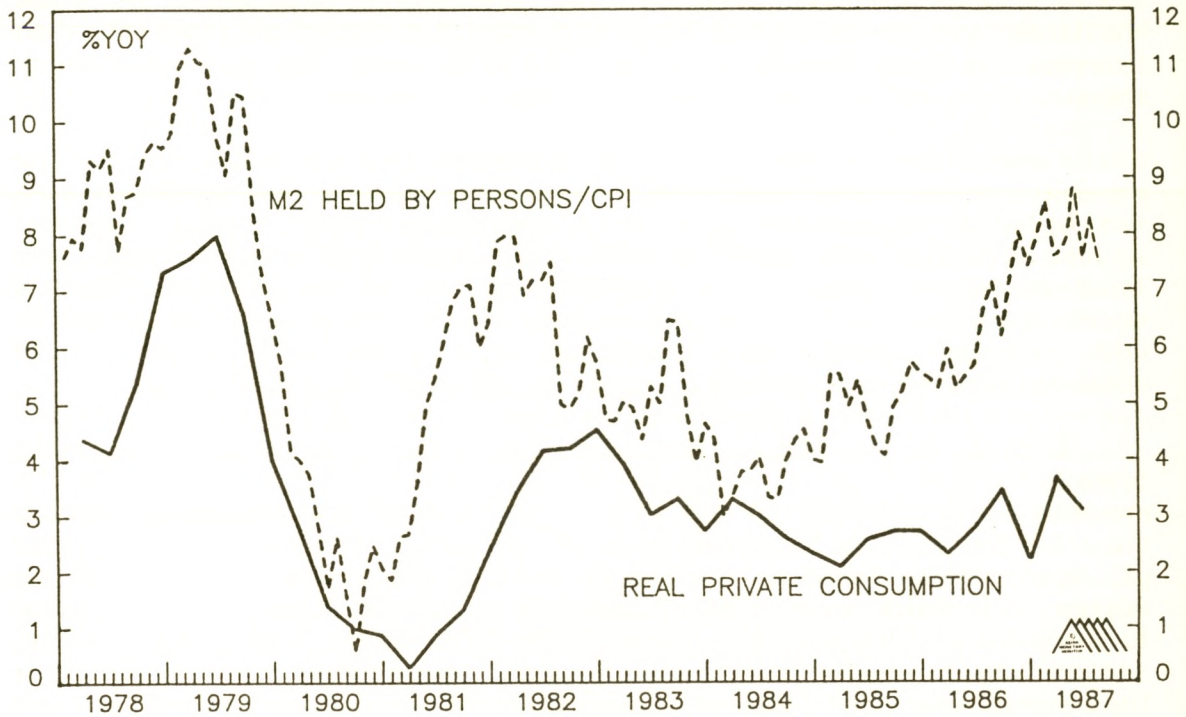
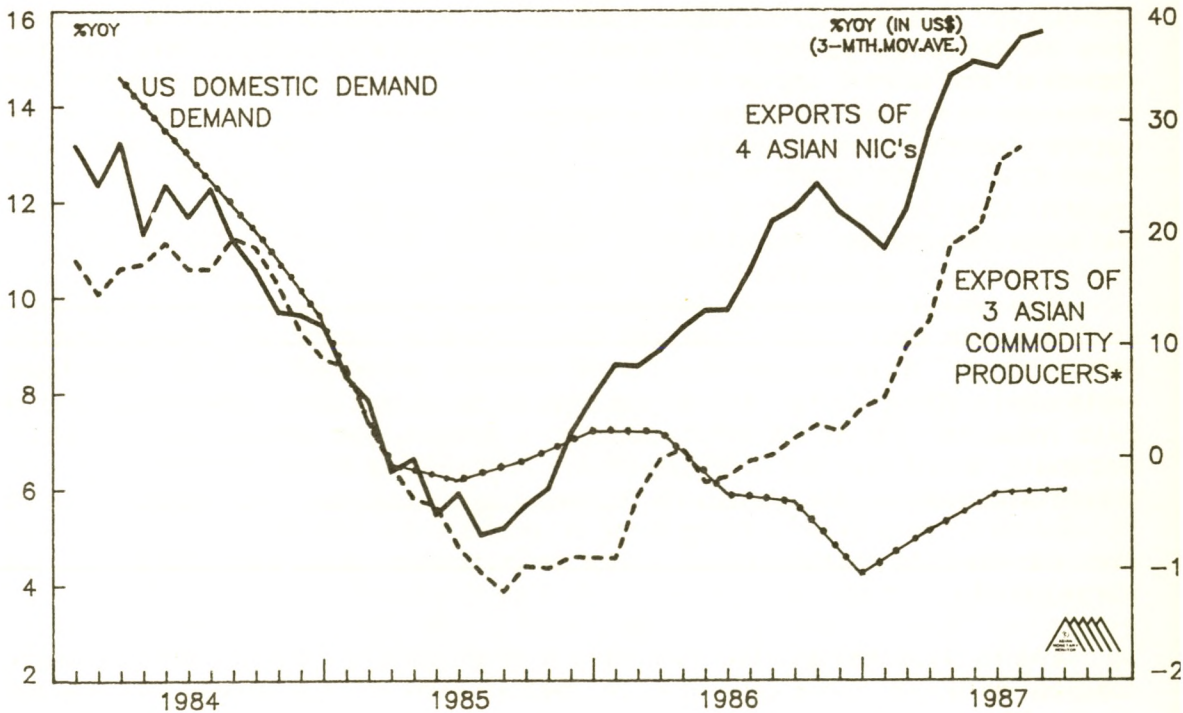


CHART 9
US DOMESTIC DEMAND AND ASIAN EXPORTS GROWTH



*MALAYSIA, THE PHILIPPINES AND THAILAND.

economic developments in Japan and which are relatively less dependent on US domestic demand. In this respect, the three major ways in which the regional economies have been benefiting from the growth of the Japanese economy and the strong yen are through i) increasing exports to Japan ii) Japanese direct investment and iii) Japanese tourism. Charts 10 to 14 provide illustrations of these trends with regard to specific countries in the region.

Chart 10 shows that by the second quarter Japanese import growth was running at a 30% annual rate (in both volume and value terms). South East Asia has benefited disproportionately from the strong rising trend in Japanese imports, with Japanese imports from the region rising at 44% year-on-year in the third quarter (see Chart 11). In the particular case of Hong Kong, as Chart 12 shows, domestic exports to Japan have been rising at an annual rate of close to 70%. Although domestic exports to Japan only form roughly 5% of Hong Kong's total domestic exports, growth in exports at this rate (or, possibly, higher in the future) can still make a significant contribution to Hong Kong's overall export growth rate. In this regard, Singapore is in much the same position as Hong Kong.

Further grounds for optimism on the prospects for Asian regional exports to Japan can be found in the results of Japanese direct investment in the region. The major regional beneficiaries of substantial Japanese investment in the manufacturing sector (the result of the Japanese manufacturing industry's tendency to move offshore in order to remain competitive in the wake of the strong yen) have been Thailand, Singapore and Malaysia (see AMM Vol. 11 No. 4). In the case of Singapore, Japan surpassed the US as the most important source of foreign investment commitments in manufacturing in 1986, and investment by Japanese companies has been growing very strongly this year (see Chart 13). As a result Japanese companies now account for roughly 40% of total investment, both foreign and local, in Singapore's manufacturing sector. Japanese investment appears likely to continue to remain strong as the yen continues to rise on the foreign exchanges. However, possibly more important for Singapore's future economic growth is the likely boost to exports which this investment - most of which is in the electrical/electronics industry - will result in, the full effects of which have by no means yet been seen. In this respect, Japanese companies established in South-East Asia will obviously be in a particularly strong position to export goods back to Japan.

Possibly even more important than Japanese imports and investment for the region is Japanese tourism. Tourist arrivals in South East Asia from Japan have been surging during 1987, in the case of Singapore the year-on-year growth rate reaching 46% in the three months to August (see Chart 14). In number Japanese tourist arrivals in Singapore are now running at an annual rate of over 500,000, accounting for about 15% of total tourist arrivals (cf. Singapore's total population of only 2.6m). Hong Kong statistics show a very similar trend, with the year-on-year growth rate of visitor arrivals from Japan reaching 63% in the three months to July. Hong Kong's statistics also illustrate another result of the strong yen. For the January to June period of 1987 for the first time per capita spending by Japanese tourists surpassed that of visitors from any other country. Coupled with the strong growth in the overall number of Japanese visitors, this meant that receipts from Japanese tourists accounted for nearly 30% of total tourist receipts for Hong Kong.

CHART 10
JAPAN EXPORTS AND IMPORTS GROWTH

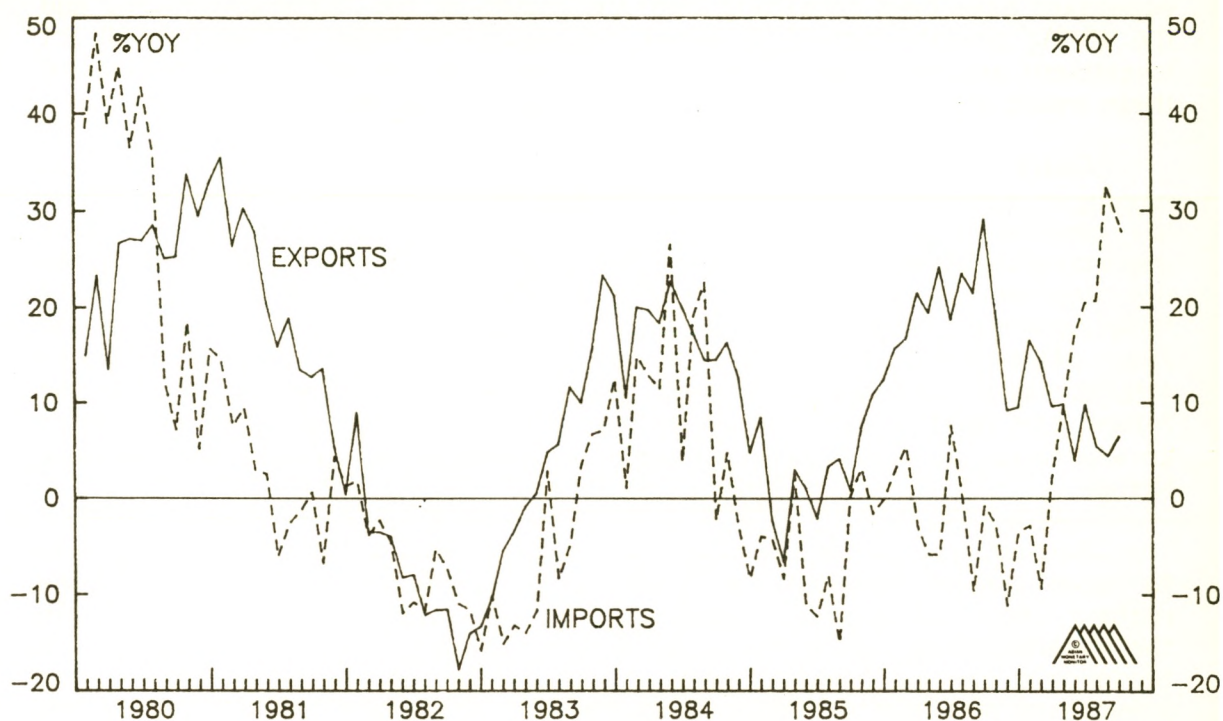


CHART 11
JAPANESE IMPORTS FROM THE US AND S.E. ASIA

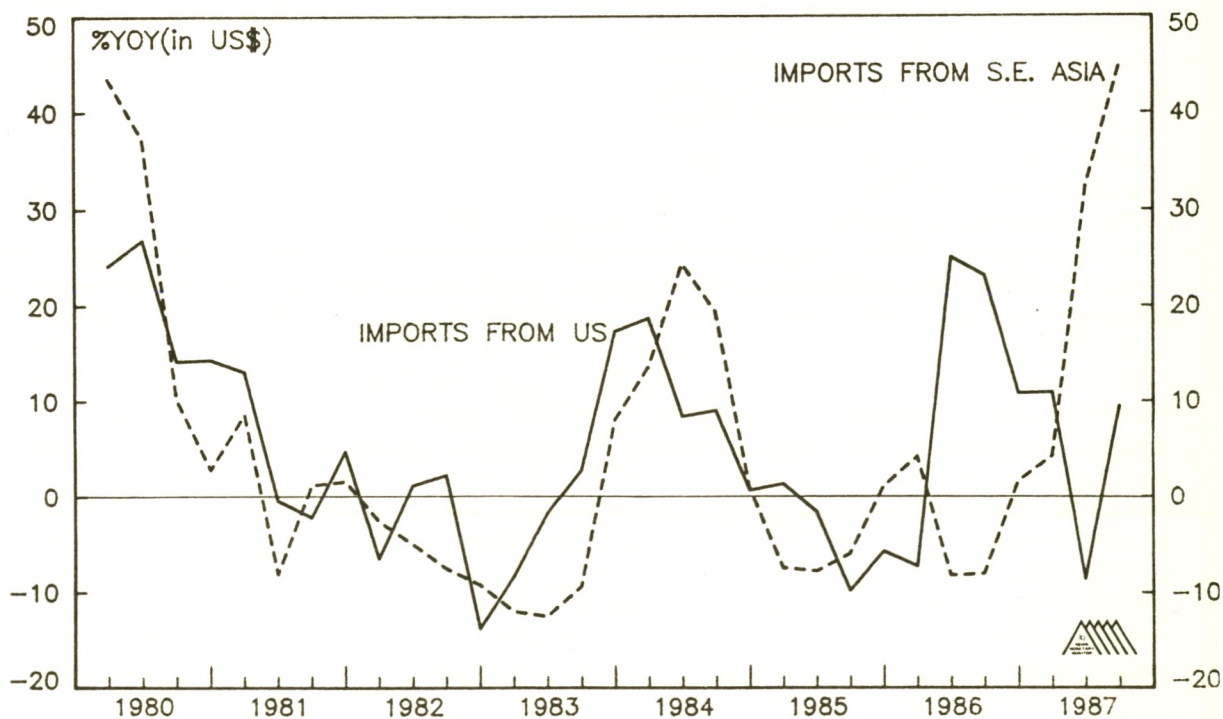


CHART 12
HONG KONG'S EXPORTS TO JAPAN ARE GROWING RAPIDLY

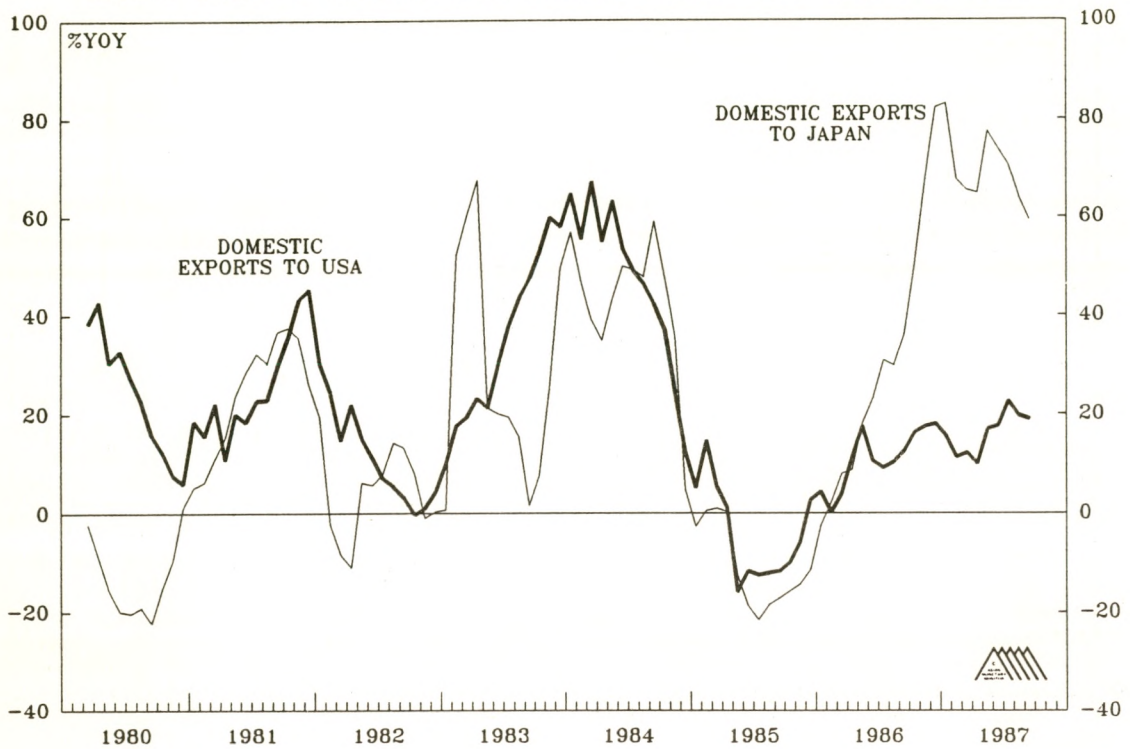


CHART 13
SINGAPORE: NET INVESTMENT COMMITMENTS IN MANUFACTURING

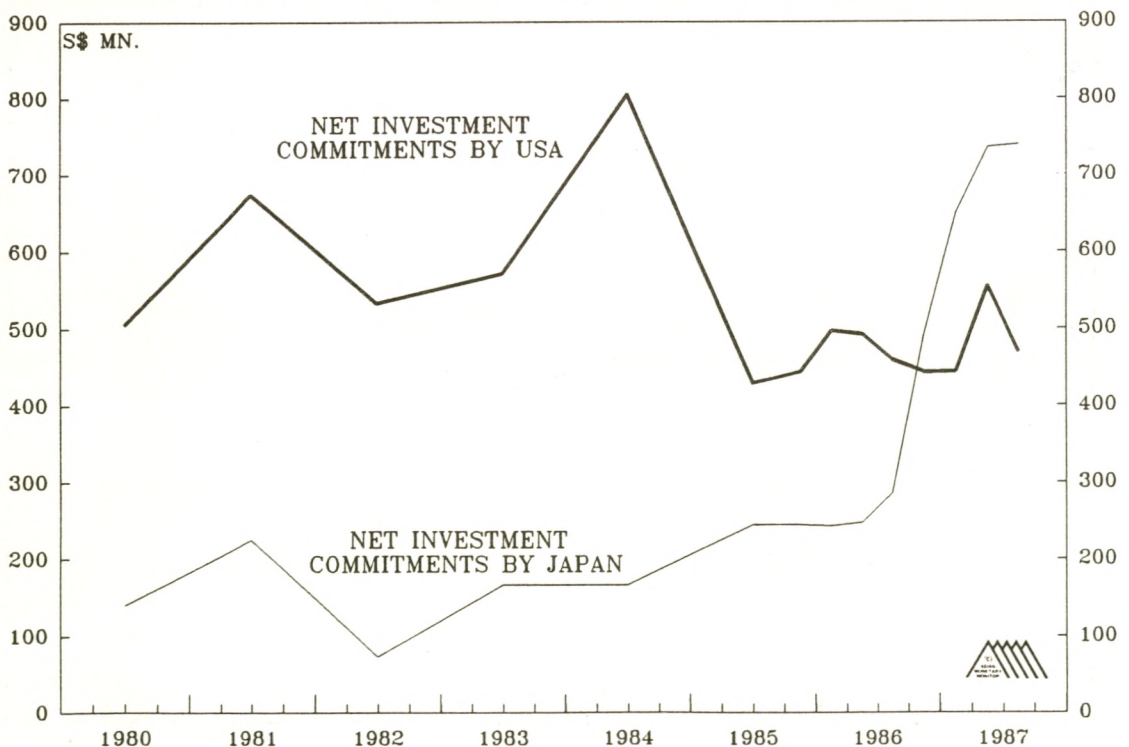


CHART 14
JAPANESE TOURISM

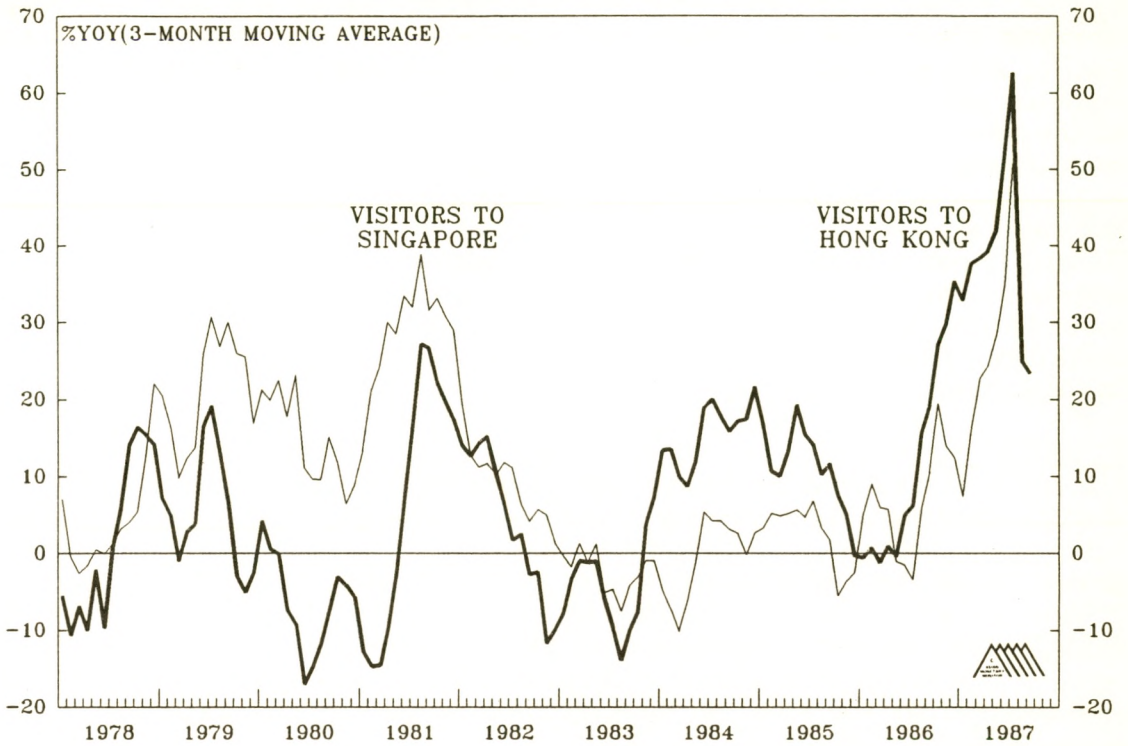
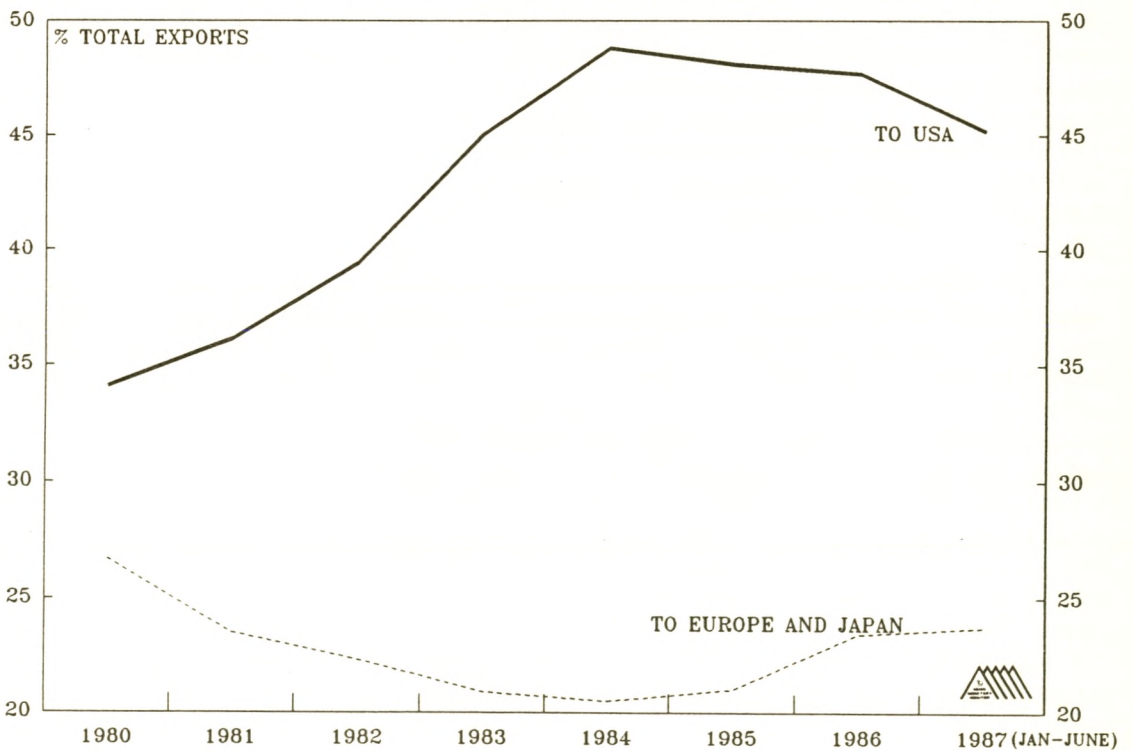


CHART 15
TAIWAN IS STILL VERY DEPENDENT ON THE US MARKET



Singapore, Thailand, Hong Kong and Malaysia can all be seen to be continuing beneficiaries of Japanese import growth, direct investment and tourism. Taiwan, unfortunately, can be singled out as the one East Asian economy which may not benefit significantly from these trends. Of all the Pacific Rim economies, Taiwan remains the most heavily dependent upon US domestic demand (see Chart 15). Furthermore, the greater than 30% revaluation of the New Taiwan dollar means that Taiwan's currency is no longer undervalued on a purchasing power parity basis and hence Taiwan's export sector is not as competitive as previously. A further consequence of the revaluation is that because Taiwanese labour costs are, as a result, no longer as low in dollar terms Taiwan is not a favoured destination for Japanese direct investment. Indeed, instead, many Taiwanese manufacturing companies are themselves looking to move production capacity offshore, including to South-East Asia. Taiwan will accordingly have to rely much more on domestically generated economic growth in the future.

FORECAST: To summarise, the stockmarket collapse of October can be seen as the result of divergent trends in monetary growth between the major economies and, in particular, tight monetary conditions in the US, which developed in the wake of the February Louvre Accord. The very marked slowdown in the rate of growth of all the monetary aggregates in the US over the course of this year implies a slowdown in domestic demand growth in the US, which is likely to be evident over the next two quarters. However, the period of weak domestic demand is unlikely to be prolonged because the Fed's prompt action to reliquify the economy in the wake of the crash should quickly encourage a recovery, probably later in 1988.

In the meantime, the declines in Asian stockmarkets appear to have been very much overdone in the light of what are likely to be continuing quite favourable economic conditions. US domestic demand has not provided the important source of growth to the smaller East Asian economies in 1987, but rather their overall competitiveness and the comparative strength of the Japanese and, to a lesser extent, European economies. The stockmarket crash has strengthened, rather than inhibited, the trends towards a weaker US dollar (and with it, weaker currencies for the South East Asian economies) and stronger domestic demand in Japan.

In particular, those commentators who have compared current economic trends with those of 1929-33 are missing two important differences between now and then. Firstly, after the 1929 Wall Street crash the Fed did not act quickly to boost monetary growth but instead subsequently allowed money supply to contract by a third. Secondly, at the current time, as a result of the stockmarket crash and the monetary easing by the Fed, other major central banks - and, in particular, the Bank of Japan - have been forced to further ease monetary conditions in their own economies in order to prevent the dollar from weakening more rapidly. The result is that monetary conditions in Japan have been very easy and that consequently strong domestic demand growth in Japan should provide a major support to overall world economic growth over the next year. The East Asian economies are particularly well positioned to benefit from the likely strength of Japanese domestic demand, and therefore should be able to record fairly good economic growth rates through 1988.

AUSTRALIA

AFTER THE CRASH, A NEED TO RE-THINK POLICY

Confidence in Australia's immediate economic prosperity has been severely dented. The sell-off which swept through the world's equity markets in late October was nowhere more pronounced than in Australia. From its peak on 19 September the All Ordinaries Index fell by 48% to its lows. The initial trigger for the fall, as elsewhere, was Wall Street's drop. This was re-enforced by foreign institutional selling to meet redemptions in the wake of the temporary closure of the Hong Kong market and the illiquidity of other bourses within the Asian region. As the fall gathered momentum a more complicated set of circumstances began to dominate market psychology. Convinced of the inevitability of a world recession, weaker commodity prices and a falling Australian dollar, institutional selling intensified. A dash for liquidity developed and the short-end of the yield curve steepened, as local institutions sold bonds to meet redemptions and foreign holders became wary of the exchange rate risk.

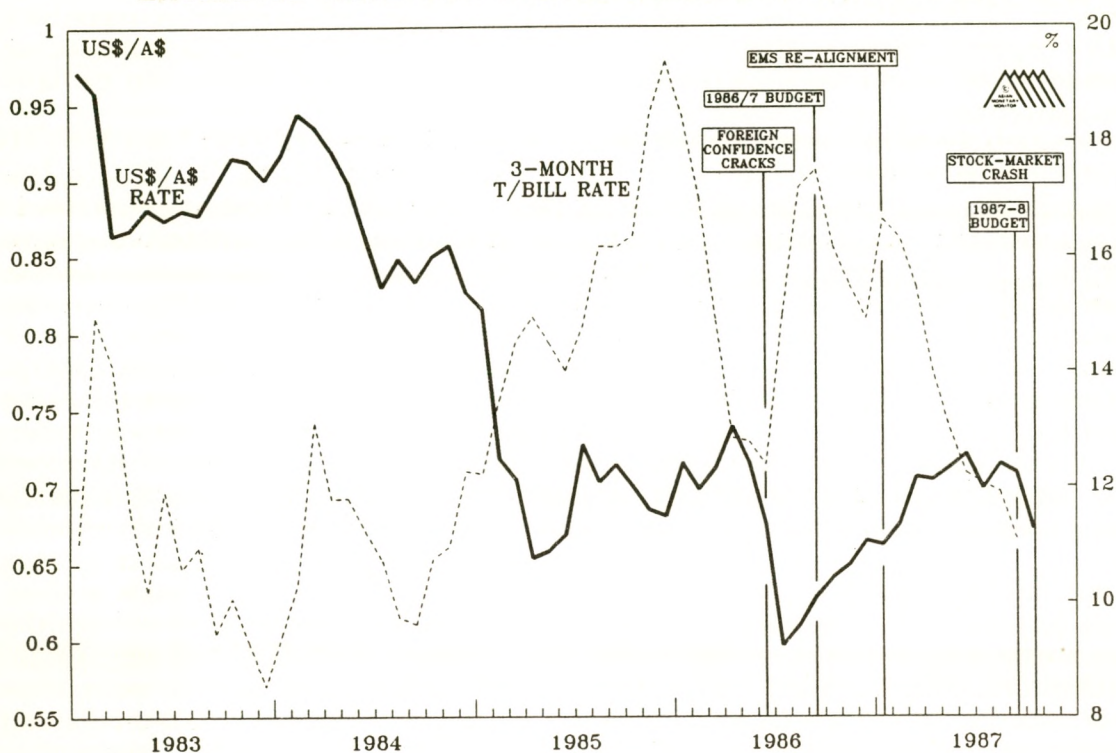
Causes of the Crash

Why was Australia so vulnerable to a foreign shock? According to the authorities, just one month earlier the economy had appeared to be in good shape and adjusting to the trends in world trade, which on a secular basis were turning against commodity producers. The commonwealth budget papers, released in September, noted that 'performance to date and the outlook for 1987/8 suggest that the intended adjustment process is underway.' The budget had planned for the virtual elimination of the central government deficit, inflation and real wages were falling, the current account deficit was narrowing and private fixed investment was picking up. One commonly advanced explanation for the severity of the crash is that the economy was still at an early stage of the adjustment. The balance sheets of both companies and the broader macro-economy had therefore only just begun to benefit and it was inevitable that confidence, which had been riding so high one month earlier, would be vulnerable.

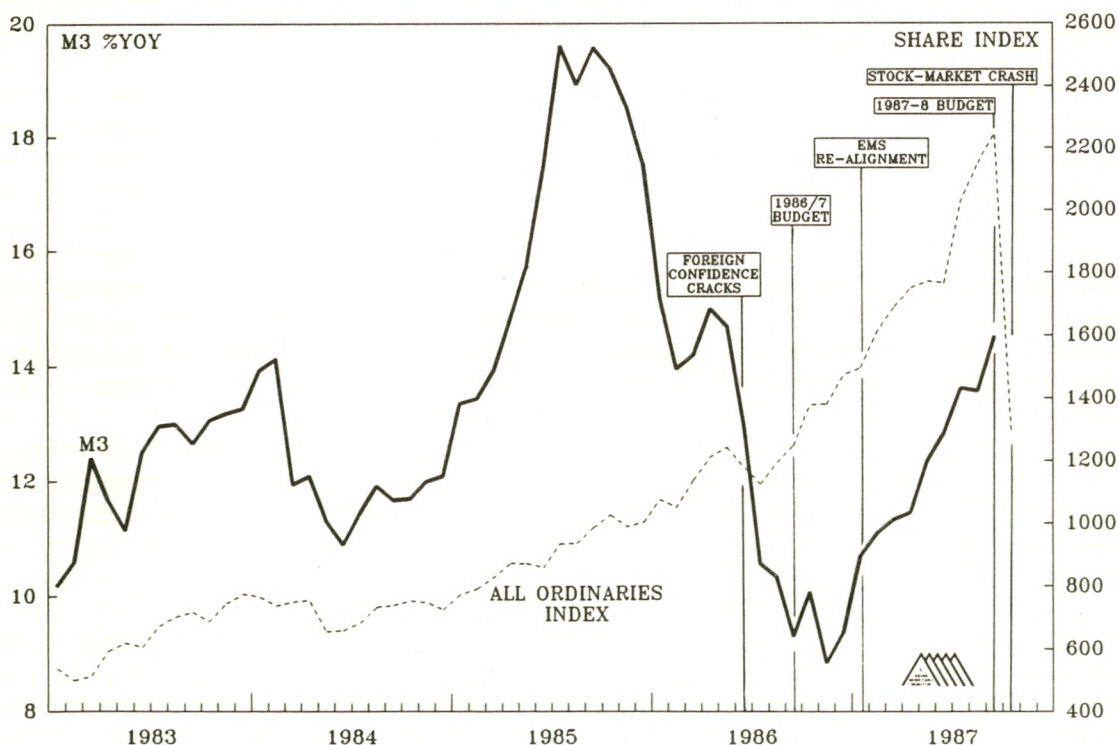
However, while containing elements of truth this explanation ignores the problems which were manifestly evident prior to the crash. A hint that potential difficulties were brewing was given less than two weeks after the budget when the Reserve Bank noted in its October monthly bulletin that: 'It will be necessary to watch that domestic growth does not pick up so strongly in the period ahead as to put new pressure on prices and the balance of payments'. In fact, monetary policy was inappropriately lax and threatened to create boom conditions. Prices in the residential property market were soaring, and credit to business was growing by over 20%. Both the arrangements and approach to monetary policy were proving to be seriously flawed.

Since the formal abolition of monetary targeting in 1985, owing to the distorting impact of the deregulation of the financial system on the aggregates, the authorities have adopted a 'checklist approach' to monetary policy. This has involved monitoring a range of indicators, including short-term interest rates, the exchange rate, the money supply, the external accounts, economic activity

AUSTRALIA: CHART 1
EXCHANGE RATE AND SHORT-TERM INTEREST RATES



AUSTRALIA: CHART 2
MONEY GROWTH AND THE STOCK MARKET



and inflation, in order to gauge the correct stance. In reality they have relied on changes in interest rates to influence private sector credit demand with the Reserve Bank's 1986 annual report noting that: 'The transmission of monetary policy depends, in the first instance, on the speed of adjustment of private sector lending rates to changes in cash conditions'. This approach has proved to have two major shortcomings.

First, in a commodity producing country, where confidence tends to settle at extremes, credit demand proved relatively unresponsive to changes in short-term interest rates. Second, since mid-1986 the authorities have been unable to influence interest rates, except in the very short term by their influence on the cash rates (equivalent to the US Federal funds rate). Although no item on the checklist has been raised to the status of a policy objective, for the last 18 months the authorities concerns were closely focused on ensuring orderly exchange rate movements. Money supply growth and short-term interest rates therefore became a residual of these operations.

Other problems associated with conducting a discretionary monetary policy were also emerging. As Australia is a small open economy, with primary products (processed and unprocessed) accounting for 60% of total exports, swings in the business cycle tend to be violent. At times the Reserve Bank's actions were further amplifying these natural swings in the business cycle. Although the checklist approach to monetary policy was designed to provide a guard against placing too much emphasis on any one indicator or development, the authorities were only picking up the signals of the need to alter policy at a late stage and the interpretations were proving highly subjective. The policy response was therefore proving inconsistent, causing wide swings in both short-term interest rates and the money aggregates (see Charts 1 and 2).

Monetary Policy Between June 1986 and September 1987

A discussion of the forces behind the movements in the exchange rate and short-term interest rates, illustrated in Chart 1, highlights these points in more detail. The Chart delineates four distinct periods in the conduct of monetary policy: June to the announcement of the 1986/7 budget in September 1986, the end of September 1986 to the EMS re-alignment in mid-January 1987, mid-January 1987 to end-January, and end-January to the reading of the 1987/8 budget in September 1987. During the first phase monetary policy was geared to supporting the exchange rate. Worries over Australia's rising external indebtedness and deteriorating terms of trade caused a crisis of confidence in the currency. Monetary policy was tightened to compensate. The Reserve Bank sold reserves to slow the currency's fall and only partially offset the impact on domestic liquidity by open market operations. By early September the exchange rate, which had traded at US67 cents in June and fallen to a low of US57 cents in July, was trading at US63 cents. Pressure on the reserves of the banking system caused money supply growth to fall further and resulted in the 3 month Treasury bill rate rising from 12.38% to 17.51% over the same period.

The Reserve Bank's support for the currency at this stage was predicated on the belief that the weakening in the exchange rate was overdone. A real exchange rate adjustment was justified by the terms of trade deterioration, but the implications of a freefall in the Australian dollar for inflation and a further

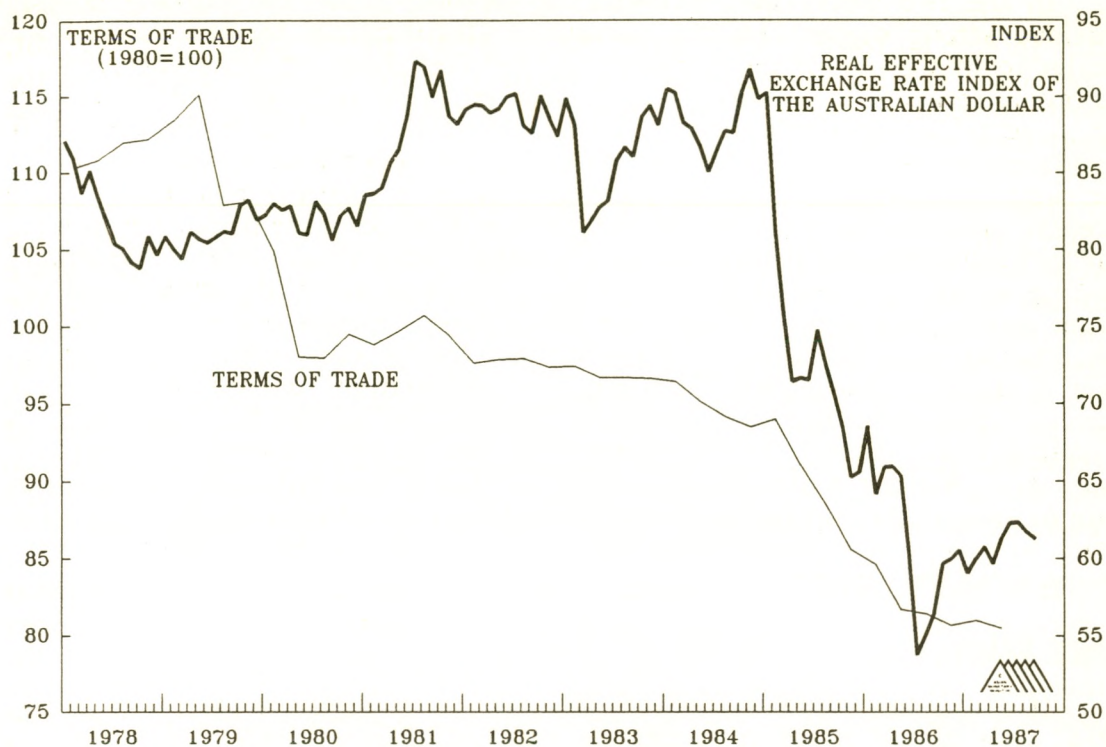
deterioration in foreign confidence, caused the authorities to moderate the decline. The important point is that the earlier fiscal policy stance which involved large scale sale of public sector debt to non-residents, as well as private sector foreign borrowing had created the conditions for the panic to occur. But, if the blame can therefore not be laid entirely on the monetary authorities the almost immediate easing in monetary policy that subsequently occurred was clearly their mistake.

The second phase - end of September 1986 to mid January 1987 - saw a recovery in the Australian dollar. The currency gained by approximately 6% against both its trade weighted basket and the US dollar as foreign confidence returned in the wake of the budget for fiscal 1986/7, which reaffirmed the authorities' commitment to contain the growth in public sector foreign debt. Although the Reserve Bank responded cautiously, there was a large net inflow of funds to the money market. The bank was a net purchaser of foreign exchange to cap the Australian dollar's rise and although they remained a net seller of government stock, it was less than the value of maturing government stock in public hands. The 3 month Treasury bill rate fell by 300 basis points from 17.51 to 14.91 by the end of December.

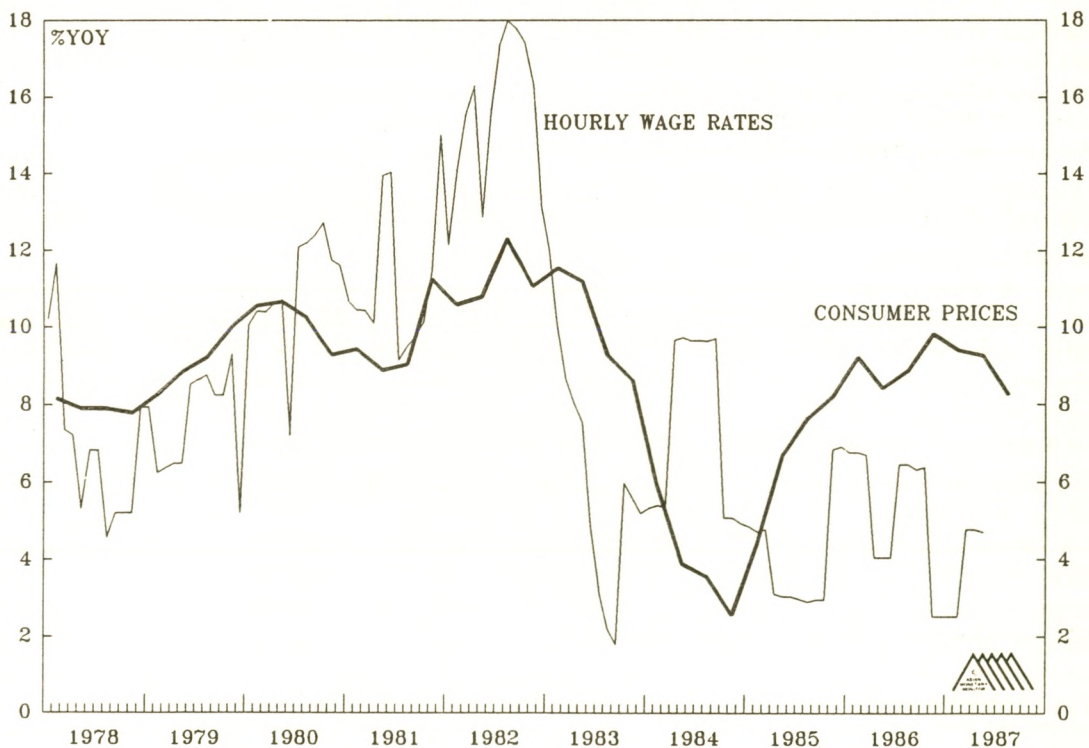
It is hard to understand how the authorities could have been convinced that an early relaxation of monetary policy was appropriate at this stage. Money supply growth (M3) had slowed to single figures (see Chart 2), but on the authorities' own admission was being severely distorted by deregulation. Inflation was continuing to rise and remained well above the levels of the other OECD countries. The authorities instead seemed to be focusing almost exclusively on the current account deficit which was showing signs of narrowing. But the trend was far from established as the deficit still remained above A\$3 billion, or over 5% of gdp, for the final quarter of calendar 1986. The financial markets remained unconvinced about the improvements and delivered their verdicts in December, when the currency came under strong selling pressure that was only offset by central bank intervention.

As Chart 3 shows the exchange rate began to recover strongly in February as foreign confidence returned. The Reserve Bank began to monetise the build-up in the foreign exchange reserves, as it once again capped the appreciation of the exchange rate. This time the relaxation had greater justification. A broader range of indicators on the checklist were indicating an easing was warranted. The improvement in the current account had been maintained, inflation was falling and broad money growth had dropped to 7.6% in April, the lowest level since the monthly collection of monetary data began in 1976. Interest rates fell - with the 3 month Treasury bill rate dropping from 16.8% at the end of January to 12.4% by the end of September and the yield curve turned positive for the first time in over a year. Again the dangers of a classic stop-go monetary policy stance engendered by a fixed exchange rate constraint were illustrated. This time, the policy response was too vigorous. Money growth accelerated rapidly, retail sales picked up strongly, employment rose and the stockmarket climbed sharply to overinflated levels, peaking the day after the budget, at a weighted average prospective price earnings ratio of over 20. The situation had all the ingredients necessary to justify a monetary tightening before events on Wall Street intervened.

AUSTRALIA: CHART 3 THE REAL EFFECTIVE EXCHANGE RATE AND THE TERMS OF TRADE



AUSTRALIA: CHART 4 WAGES AND INFLATION



In the two weeks that followed the October crash the authorities again provided strong support for the currency. Justification for the support was similar to that given for their intervention between June and September 1986. A perceived terms of trade deterioration justified a real exchange rate adjustment, but panic set in and threatened to cause a free-fall in the dollar. Fearful of the consequences for inflation the authorities had the delicate task of supporting the exchange rate, without allowing their operations to result in higher short-term interest rates and further undermine fading confidence in the banking system. A run on Rothwells, a merchant bank, generated doubts about some of the smaller banking institutions and resulted in many depositors switching their funds into larger institutions. Open market operations were therefore undertaken to offset the drain on liquidity induced by the support for the currency. The Treasurer, Paul Keating, subsequently justified the intervention on the grounds that economic pessimism had been overdone. The reaction of the Australian dollar to a smaller than expected October current account shortfall seemed to justify this approach. But again the relevant point is that it was the authorities' earlier intervention in the foreign exchange markets between February and September, which substantially inflated the economy and left the currency vulnerable, which necessitated the support.

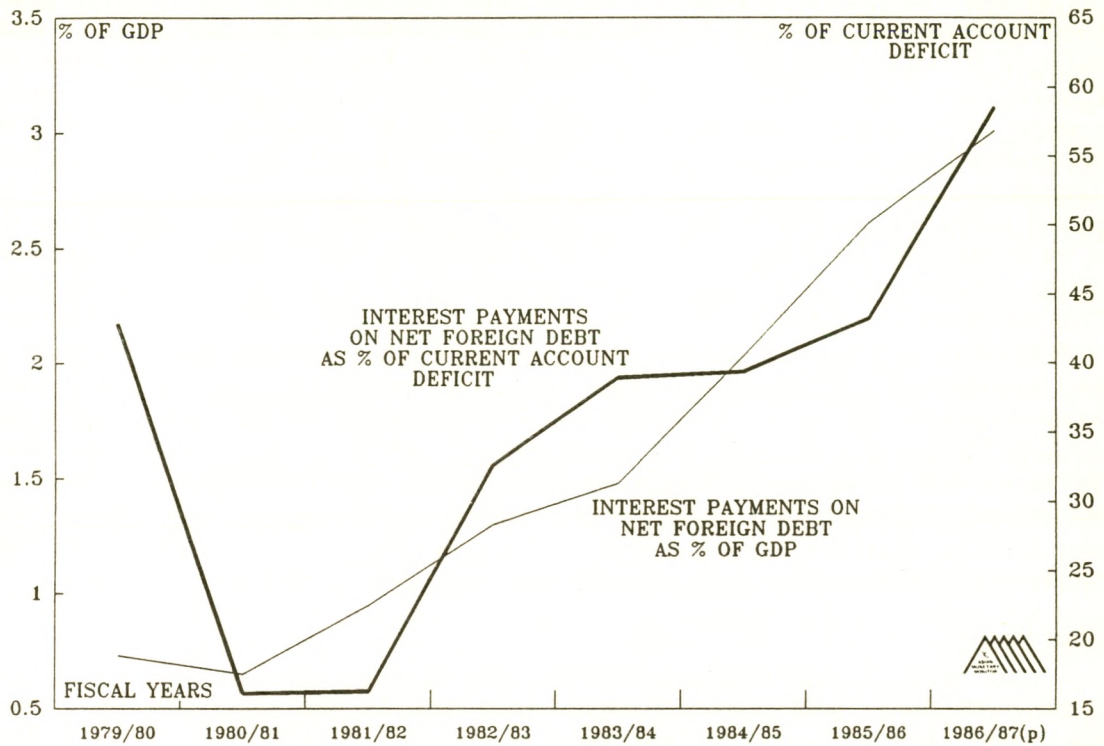
Wages Policy

If a defence of the Reserve bank's actions through the period since mid-1986 were to be made it would be that the institutional realities of the Australian economy gave them little choice. Deregulation of the financial system and the monetisation of the economy made money targeting extremely difficult, and their task was further complicated by the lack of deregulation in other sectors. The inflexibility inherent in Australia's central wage bargaining system proved a particular problem. Under the current wage accord structure two tiers exist. The first tier grants wage increases irrespective of productivity gains. In short it provides across the board increases. The second tier links wage rises to productivity improvements. Proponents of the success of the wages accord highlight the large fall in real wages over the last year, and the impact this had in improving the competitiveness of Australian exporters (see Charts 3 and 4).

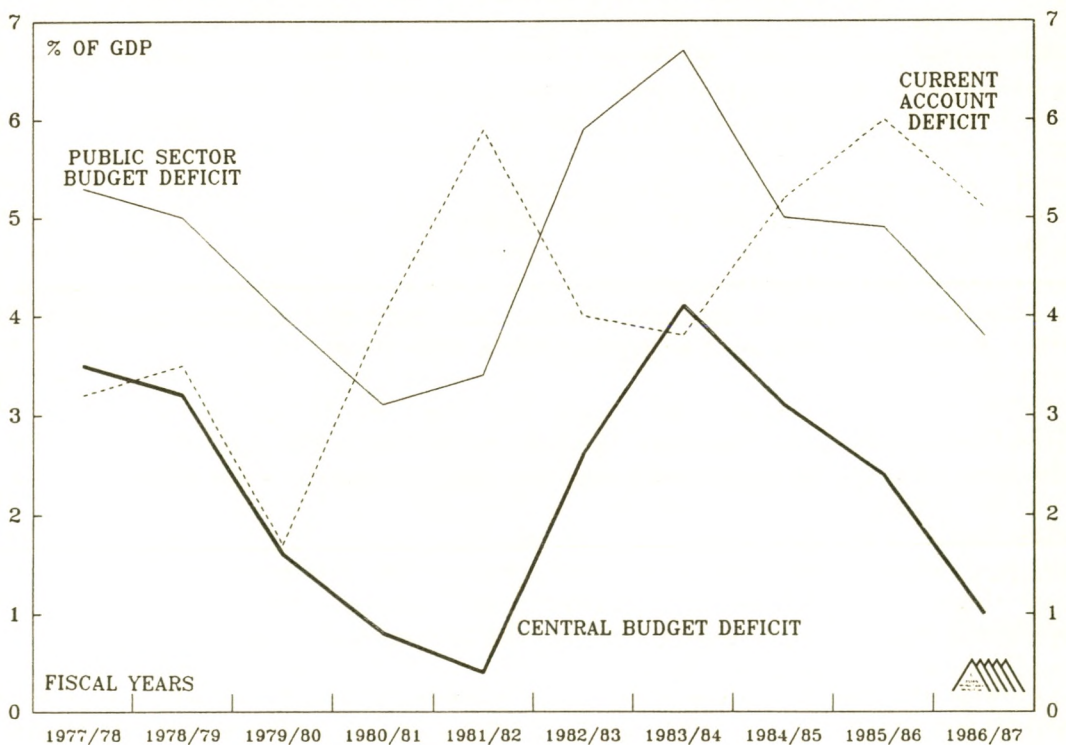
These observations miss the point. The important indicator is unit wage costs - a factor which is explicitly recognised by the second tier structure. However, under the first tier agreement the impact of the across the board wage increases is to worsen the plight of those industries which are already in most difficulty. Although wage settlements have been captured in the macro-economic data as declines in real wages, unit wage costs have been rising in industries where output is stagnating or declining. This has implications for the central bank's intervention in the foreign exchange markets. It has made them keen to moderate rises in the Australian dollar, because of the fear that competitive losses will add to the plight of troubled industries and undermine their desire to broaden the export base.

Likewise the bank's moderation of currency depreciations can also be linked to the desire to maintain the wage accord. The general argument here is

AUSTRALIA: CHART 5
 RISING FOREIGN INDEBTEDNESS



AUSTRALIA: CHART 6
 PUBLIC SECTOR AND CURRENT ACCOUNT DEFICITS



that a depreciating currency generates inflation which could make the unions less reluctant to honour the wage agreement. Under a flexible exchange rate system with money targeting, exchange rate changes alter the relative price level between traded and non-traded goods. The secondary impact of a devaluation feeds through into the absolute price level only if the monetary stance allows it to. If the money targets remain unaccommodating, any rise in unit wages costs which results from monopoly trade union power feeds through into higher unemployment. The political desire to maintain a close working relationship between government and unions, an important element of which is to prevent unemployment from climbing, precludes this option in Australia.

Deregulation

If there is a theme which runs through all this it is that deregulation and decentralisation of the Australian economy needs to accelerate. The deregulation of the financial markets and the floating of the Australian dollar occurred during the first Hawke administration (March 1983-December 1984). The latter was shortlived. Despite the distinction that has been made between smoothing exchange rate changes and having an exchange rate target, the behaviour of interest rates and the money aggregates, notwithstanding the distortions introduced by deregulation, has been similar to that which would be expected under the fixed exchange rate system that operated prior to 1983.

Our analysis has concentrated on the damage intervention did in the monetary sphere, and its interaction with the labour market. There are numerous other examples in the real economy. During the second Hawke administration the government established the Business Regulation Review Unit, which has highlighted both the high cost to government and the private sector of regulation. But progress in implementing its recommendations has been relatively slow and liberalisation in the three important areas of agriculture subsidisation and pricing, domestic communications and the labour market has yet to receive serious attention. The realisation that these distortions pose serious obstacles to the efficient allocation of resources and hence reduce the country's economic potential is evident from the Treasury's reference in the last set of budget papers to the effect current labour market practices were having in slowing the speed of the structural adjustment. However, political 'realities' are dominating, with the politicians' desire not to antagonise their electoral constituency at the forefront of concerns. A more comprehensive analysis of the need for further and faster deregulation falls outside the scope of this article, but at present it seems as though progress will be slow.

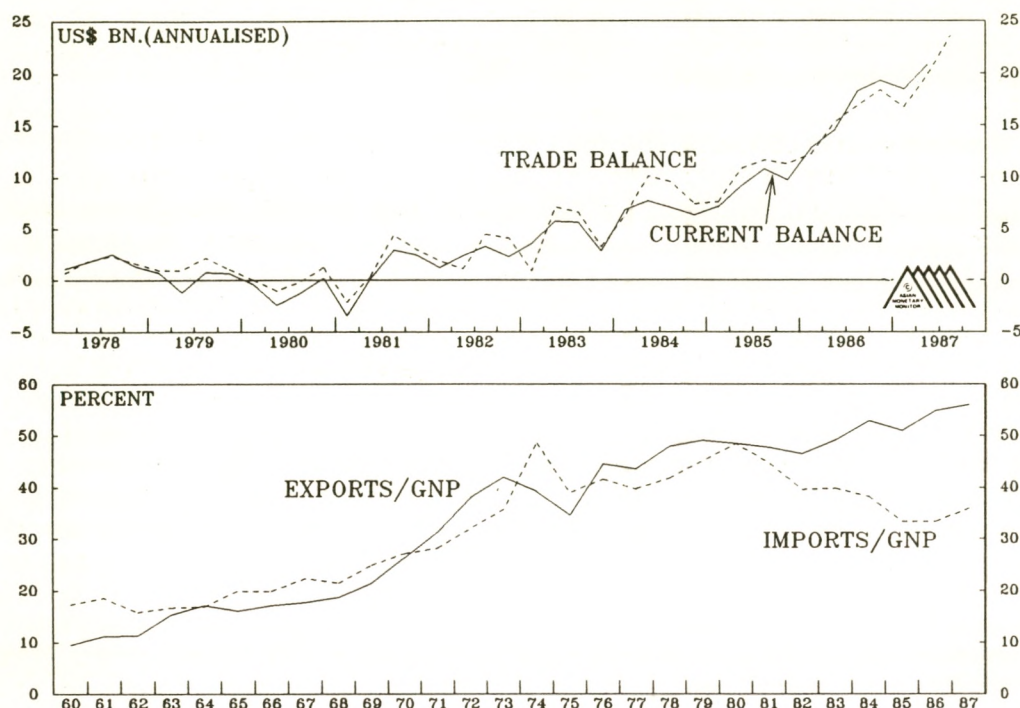
FORECAST: The model for analysing the immediate prospects for the Australian economy is therefore unlikely to be much changed from the one we have used to trace developments over the last 18 months. Perceptions of terms of trade changes will continue to dominate psychology. Central bank intervention will also continue to magnify swings in the business cycle. Monetary policy will remain cautious, though the difficulties being faced by many investment banks and brokers will almost certainly preclude any substantial tightening. Despite recent falls in commodity prices, spot prices still remain above contract prices entered into by Australian exporters earlier this year. The effects of any terms of trade deterioration will therefore only be felt at the beginning of the next fiscal year. The extent of the shock in the financial

markets will probably allow the government to push through lower wage increases in the next wage round and achieve further reductions in real government expenditure to compensate. A balanced budget at central government level will be accompanied by further declines in the broader public sector borrowing requirement.

Consequently, although the high rate of growth during the first quarter of the fiscal year (July to September) will ensure that the budget estimate of 2.75% real GDP growth for the fiscal 1987/8 is achieved, growth through the next two quarters is likely to slow. The decline in the currency in October will undoubtedly cause a temporary reversal of the recent improvement in the current account measured in Australian dollar terms via the J curve effect. Some future nervousness in the currency markets can therefore not be ruled out. But as it is likely that the US Federal Reserve Board has injected sufficient liquidity to ensure the US economy does not go through more than two quarters of economic slowdown (see this AMM page 17), the Australian recession is likely to be short-lived. Any terms of trade improvement is likely to be met by a cautious easing of monetary policy, and the rapid expansion in Australian gold production due during the next 2 years will benefit the economy when any worldwide inflationary pressures which emerge in the later stages of the current world business cycle, emerge.

But the country's secular economic performance will remain poor. Thus far the uncertain monetary environment has limited the improvement in private sector fixed investment spending to the commercial property market. Investment in plant and machinery has remained disappointing. Until monetary policy becomes more consistent and the deregulation in the real economy gathers momentum, this is unlikely to change significantly.

TAIWAN: TARIFF REFORMS WILL SPEED TRADE ADJUSTMENT



Taiwan has just announced its fourth tariff reduction of the year. The cuts are supposed to average 50% on 3,520 imported items. This is 81% of the 4,383 import line items in the current tariff tables. Most tariff rates will be below 20% with the exception of a few products. This action should speed the adjustment of Taiwan's trade surplus which has been as high as 20% of GNP.

Taiwan has been revaluing aggressively, with the exchange rate moving to US\$1=NT\$29 from NT\$40/US\$ in the last 18 months. This large revaluation (37.9%) has not reduced Taiwanese exports nor increased imports sufficiently to close the trade imbalance. Unless the effects are blunted by bureaucratic obstacles, the lower tariffs and the progressive revaluation should now move Taiwan rapidly toward more balanced trade.

This will have important ramifications for other macroeconomic variables. First, the Central Bank of China will not be forced into such large sterilizations since increased imports will reduce the upward pressure on the money supply which had been resulting from the trade surplus. This will allow interest rates to fall relative to what they would have been and therefore domestic investment will be higher. Second, if imports do increase dramatically, the authorities will be able to stop the continual revaluations that have been forced on them by US pressure. Third, since in the long run trade must be balanced, Taiwan will be able to continue its high rates of export growth which now will be matched by import growth. This implies that Taiwan's economic "miracle" can continue to its next stage, with increased levels of consumption occurring along with increased production and even more trade. (See the Chart above for the record of Taiwan's growing trade orientation.)

